CHAPTER 1

AN INTRODUCTION TO FOREIGN CAPITAL FLOWS INTO INDIA

The theoretical arguments in support of foreign capital flows are quite persuasive. By affording the opportunity of using the world market, an open capital account permits both savers and investors to diversify their portfolios to maximize returns and minimize risks. Capital flows could also potentially develop nascent financial markets, promotes financial disciplines, provides modern technologies, modern management practices, employment opportunities and reduce the borrowing costs both for the government and corporate. Moreover, it is important for developing countries like India to bridge the gap of savings and investment rate. On flip side, however, capital flows are known to be procyclical and they complicate the macroeconomic management. In this background, the present chapter makes an attempt to study the various aspects of foreign capital flows to India.

INTRODUCTION

Foreign capital has significant role for every national economy regardless of its level of development. For the developed countries it is necessary to support sustainable development. For the developing countries, it is used to increase accumulation and rate of investments to create conditions for more intensive economic growth. For the transition countries¹, it is useful to carry out the reforms and cross to open economy (Edwards, 2004), to cross the past long term problems and to create conditions for stable and continuous growth of GDP (Razin, 2001), as well as integration in world economy (Boskovska, 2006; Lensik, 1999). But, capital flows from developed to developing countries are worth studying for a number of reasons. Capital inflow² can help developing countries with economic development by furnishing them with necessary capital and technology. Capital flows contribute in filling the resource gap in countries where domestic savings are inadequate to finance investment. Neoclassical economists support the view that capital inflows are beneficial because they create new resources for capital accumulation and stimulate growth in developing economies with capital shortage³. Capital inflows allow the recipient country to invest and consume more than it produces when the marginal productivity of capital within its borders is higher than in the capital-rich regions of the world. Foreign capital can finance investment and stimulate economic growth, thus helping increase the standard of living in the developing world. Capital flows can increase welfare by enabling household to smooth out their consumption over time and achieve higher levels of consumption. Capital flows can help developed countries achieve a better international diversification of their portfolios and also provide support for pension funds and retirement accounts into the twenty-first century. Capital inflows facilitate the attainment of the millennium development goals (MDGs⁴) and the
objective of national economic, empowerment and development strategy (NEEDs). As the economy becomes more open and integrated with the rest of the world, capital flows will contribute significantly to the transformation of the developing economy (Levin, 2001). However, large capital inflows can also have less desirable macroeconomic effects, including rapid monetary expansion, inflationary pressures, and real exchange rate appreciation and widening current account deficits. Hence, a surge in inflows of the magnitudes seen in recent years may pose serious dilemmas and tradeoffs for economic policy, especially in the present environment of high capital mobility. History has also shown that the global factors affecting foreign investment tend to have an important cyclical component, which has given rise to repeated booms and busts in capital inflows.

**CONCEPTUAL FRAMEWORK OF CAPITAL INFLOWS**

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

**Foreign Direct Investment:** Investment that is made to acquire a controlling interest (usually 10 per cent of voting stock) in an enterprise operating in a country other than that of the investor. The investor gets an effective voice in the management of the company. Most concretely, it may take the form of buying or constructing a factory in a foreign country or adding improvements to such a facility, in the form of property, plants, or equipment. FDI is calculated to include all kinds of capital contributions, such as the purchases of stocks, as well as the reinvestment of earnings by a wholly owned company incorporated abroad (subsidiary), and the lending of funds to a foreign subsidiary or branch. The reinvestment of earnings and transfer of assets between a parent company and its subsidiary often constitutes a significant part of FDI calculations. According to the United Nations Conference on Trade and Development (UNCTAD), the global expansion of FDI is currently being driven by over 64,000 transnational corporations with more than 800,000 foreign affiliates, generating 53 million jobs. An Indian company may receive FDI under the two routes Automatic Route and Government Route (Appendix 1).
Foreign Portfolio Investment\(^{10}\): It consists of Depository Receipts (DR), Foreign Institutional Investment (FII\(^{11}\)) in debt and equity (direct purchase of shares). The major institutional investors are mutual funds; asset management companies (AMCs\(^{12}\)), pension funds and insurance companies. The Reserve Bank of India monitors the ceilings on FII/NRI/PIO investments in Indian companies on a daily basis\(^{13}\) (Appendix 2).

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

Foreign Institutional Investment: The term foreign institutional investment denotes all those investors or investment companies that are not located within the territory of the country in which they are investing. These are actually the outsiders in the financial markets of the particular company. Foreign institutional investment is a common term in the financial sector of India. International institutional investors must register with the Securities and Exchange Board of India to participate in the market\(^{14}\). One of the major market regulations pertaining to FIIs involves placing limits on FII ownership in Indian companies.

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

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

**MACROECONOMIC EFFECTS OF CAPITAL INFLOWS**

Capital inflows are necessary for macroeconomic stability as capital inflows affect\(^{15}\) a wide range of macroeconomic variables such as exchange rates, interest rates, foreign exchange reserves, domestic monetary conditions as well as saving and investments.
Fitz Gerald (1998) theoretically argues that higher capital inflows lower interest rates, which helps increase investment and economic growth. Some commonly observed effects of the capital inflows that have been documented in the studies (Calvo et al., 1994; Calvo and Reinhart, 2000; Hutchison, 2002; Ito, 2006; Jitter, 2003; Kaminsky, 2003 amongst others) include real exchange rate appreciation, stock market and real estate boom, reserve accumulation, monetary expansion as well as effect on production and consumption. Macroeconomic effect of the renewal of foreign lending to developing countries described as:

First, a substantial portion of the surge in capital inflows has been channeled to accumulation of Foreign exchange reserves. Second, in most countries the capital inflows have been associated with widening current account deficits. Third, as one would expect from the fall in national saving, there has been a rise in private consumption spending. While disaggregated data on consumption are not available for most of the developing countries, the import data suggests the consumption boom is heavily driven by rising imports of durable goods. Fourth, in almost all the countries examined there is rapid growth in the money supply in both nominal and real terms. This follows logically, enough, from the acceleration in economic activity observed in the receiving countries and in some instances including Argentina, Brazil, Chile and Mexico from a reduction in the opportunity cost of holding money, as domestic inflation was reduced. However, several countries have demonstrated that it was possible, even in the face of large capital inflows (at least in the short run), for the central bank to curb the acceleration in the growth of the money supply. Fifth, the surge in portfolio flows to the Asian and Latin American countries was accompanied by sharp increases in stock and real estate prices. In addition, most of the countries that experienced a substantial real exchange rate appreciation had ongoing inflation stabilization plans during the inflow period. Generally problem arises when the flows are largely in excess of the economy’s absorption capacity and also when they are highly speculative in nature. Stylistically, there are three policy options to counter the adverse macro impact of volatile capital flows. The first option is to do nothing (exchange rate option) in which case exchange rate will appreciate. The second is to allow for flows to come in but intervene in the forex market (reserve accumulation option). The third option is to deploy capital controls. Typically emerging market economies have adopted a mix of all the options.

**CAPITAL FLOWS INTO INDIA**

International capital flow such as direct and portfolio flows has huge contribution to influence the economic behavior of the developing countries positively. Prof. John P. Lewis pointed out “that almost every developed country of the world in its developing stage had made the use of foreign capital to make up deficiency of domestic savings”. In the seventeenth and eighteenth century England borrowed from Holland and in the nineteenth and twentieth century England gave loans to almost every other country. United State of America, today the wealthiest country of the world, had borrowed
heavily in the nineteenth century\textsuperscript{16}. The half century prior to the First World War was a period uniquely favorable to the free movement of international capital. Even before 1914, certain changes were taking place in the character and in the industrial distribution of the international capital movements. The war not only accelerated this process by dramatically altering the position of lending participants but heralded an era which eventually had a fundamental effect on the whole climate of international capital movements. In the twenties, however there were few signs of upheaval to come and, by 1929, the total investment debt was of the same order as that in 1913. On the face occurred was the emergence of US as the prime lender and the transformation of continental Europe from a substantial creditor into a substantial debtor. Even by 1919, the US had invested $6.5 billion abroad, excluding the large war loans to the allies. In the following decades, her foreign investments rose by US $8.3 billion-about two-thirds of the world total investment raising America’s total capital stake in 1930 to US $15.7 billion. By contrast, most European countries were forced to relinquish large quantities of their foreign assets during the war; UK gave up 15\% of hers, France over half of hers and Germany nearly the whole. Since the war, a remarkable resurgence has taken place in the international capital movements, the volume of which has risen much faster than that of world trade and industrial production during the last fifteen years. In the period 1946-1950 the net flow of private long term capital from the traditional capital-exporting countries averaged US $1.8 billion per annum (equals to one-half of the average for the 1920s). In the following decade it rose to US $2.9 billion per annum reaching a peak of US $3.6 billion in 1958; since then it has fallen somewhat to less than US $2 billion in the early 1960s.

The 1970s witnessed a remarkable boom of capital flows to emerging economies\textsuperscript{17}. The dramatic surge in international capital flows was triggered by the oil shock in 1973-1974, the growth of the Eurodollar market and the remarkable increase in bank lending during 1979-1981. Latin America was the main recipient of this heavy capital inflow, with capital flows to the region peaking at US $44 billion in 1981. Overall, capital inflows to this region, which mostly took the form of syndicated bank loans, reached about 6 per cent of the region’s gross domestic product (GDP). The pace of international lending came to an abrupt end in 1982 with the hike in world real interest rates to levels not seen since the 1930s. Suddenly, emerging countries became the pariahs of international capital markets and they were not only excluded from voluntary capital markets but also forced to run current-account surplus to repay their foreign debts. By the late 1980s, there was a revival of international lending. While flows to Latin America made a tremendous comeback, capital inflows to Asia also surged, with capital flows increasing tenfold from their averages in the early 1980s. India is a developing country, like many other developing countries, international capital flows have significant potential benefit on the Indian economy. The problems of foreign investment in India have been an issue of outstanding importance ever since the days of the East India Company and added significance after Indian
Independence in 1947. In the 1950s and 1960s, the dominant form of foreign capital was foreign aid, mainly through government to government transfer of resources. In the late 1960s and early 1970s, foreign direct investment (FDI) came into prominence. The dominant form of foreign capital in the 1970s was the foreign private loan (FPL). In the late 1970s there was hardly any new foreign investment in India: indeed, some firms left the country. Inflows of private capital remained meager in the 1980s: they averaged less than $0.2 billion per year from 1985 to 1990. In the 1990s, as part of wide ranging liberalization of the economy, fresh foreign investment was invited in a range of industries. Inflows to India rose steadily through the 1990s, exceeding $6 billion in 1996-97. The fresh inflows were primarily as portfolio capital in the early years (that is, diversified equity holdings not associated with managerial control), but increasingly, they have come as foreign direct investment (equity investment associated with managerial control). Though dampened by global financial crises after 1997, net direct investment flows to India remain positive. Under the liberalized foreign exchange transactions regime, the results were dramatic. The liberalization of portfolio investment led to a surge in inflow of capital for investment (Mody and Murshid, 2002) in the primary and secondary market (Dash and Sumanjeet, 2005) for Indian equity and corporate and subsequently sovereign bond market.

**TRENDS IN INDIA**

During the early phase of planning era, the national policy towards foreign capital did recognize the need of foreign capital, but decided not to permit it a dominant position. Consequently, foreign collaboration had to keep their equity within the ceiling of 49 per cent and allow the Indian counterpart a majority stake. Moreover, foreign collaborations were to be permitted in priority areas, more especially those in which India had not developed capabilities. But in an overall sense, India’s policy towards foreign collaborations remained restrictive and selective. Consequently, during 1948 to 1960, a total of 1,080 foreign collaborations were approved and during the next decade (1961-70), a total of 2,475 foreign collaborations were approved. During 1971-80 and 1981-90 the collaborations were 3,041 and 7,436 respectively (Table 1.1).

<table>
<thead>
<tr>
<th>Period</th>
<th>Technical Collaboration Agreement</th>
<th>Foreign Collaboration Agreement</th>
<th>Total number of Foreign Collaboration</th>
</tr>
</thead>
<tbody>
<tr>
<td>1848-60</td>
<td>1,080</td>
<td>-</td>
<td>1,080</td>
</tr>
<tr>
<td>1961-70</td>
<td>1,675</td>
<td>800</td>
<td>2,475</td>
</tr>
<tr>
<td>1971-80</td>
<td>2,623</td>
<td>418</td>
<td>3,041</td>
</tr>
<tr>
<td>1981-90</td>
<td>5,595</td>
<td>1,841</td>
<td>7,436</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>10,973</td>
<td>3,059</td>
<td>14,032</td>
</tr>
</tbody>
</table>

Source: Compiled by researchers from various sources

It is revealed from the table that 78 per cent of total agreements (14,032) were technical collaboration agreements and only 22 per cent were related to direct foreign
investment. With the introduction of reforms process in the early 1990s and after the announcement of New Industrial Policy, 1991, India has witnessed a significant increase in cross-border capital flows, a trend that represents a clear break from the previous two decades. Net capital inflows increased from US$1985 million in 1990/91 to US$10725 million in 2006-07 and further to US$ 28924 million during 2007-08. After that, in 2008-09 Net capital inflows decreased to US$1406 million and up to July- September 2009-10 Net capital inflows again reached to US$23613 million (Figure 2). India has one of the highest net capital flows among the emerging market economies (EMEs) of Asia. Prior to the recent global financial crisis, India achieved above 9% GDP growth for three years in a row (2005-06 to 2007-08). A strong global growth environment and large capital inflows played a significant role in this growth acceleration trend. The 2008 crisis abruptly interrupted this story, pushing the country’s GDP growth down to 6.7, reminding India the importance of capital inflows, which was believed to be underappreciated by policymakers during the pre-crisis period. As the adverse impact of credit crisis in US ebbed, the capital flows into India again accelerated. The net capital inflows during the 12 months ended March 2010 were about US $54 billion (4.1% of GDP). This compares with an outflow of US$ 4.7billion (-0.8% of GDP, annualized) during the six months ended March 2009. Unfortunately, the trend in capital inflows into India is highly influenced by global risk appetite more than the growth opportunity in India. The trends in Capital inflows into India follow the same momentum as that for other emerging markets. India has high domestic savings to GDP and, prima facie, some may argue that the damage from the reversal in capital inflows should be negligible, but clearly, the recent trend indicates that is not the case. The trend of net capital into India can also be shown as:

Figure 1.1: Net Capital Inflows into India (US$ Million)

Source: Reserve Bank of India

Figure 1.1 reveals that in post reform period there has been remarkable increase in foreign capital. It is also important to note that capital inflows increased extensively since 2005. However, capital inflows resumed during 2007-08 to 2008-09 as a consequence of a global system awash with liquidity. presently, while most “emerging markets” in Latin America and Asia are expressing concern about and responding with capital controls to the surge in foreign capital inflows into their financial markets, policymakers in India are more optimistic and are declaring that the
country can absorb far more than the net capital inflows it currently attracts. India needs to increase the long term investments to expand the economy more strongly, foreign direct investment (FDI), although short term capital inflows from foreign institutional investor investments (FII) are rising quickly. The net FII recorded US$34 billion in the 10 months period since January 2010. However, the long term investment of FDI dropped to US$16 billion in the period from January to September 2010, down from US$21 billion for the same period last year (Figure 1.2).

Figure 1.2: Capital Flows to India since 2005 (FDI and FPI)

Source: Blog.securities.com

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

MAGNITUDE

India’s strong capital flows reveal sustained economic growth of India, positive investment climate, favorable liquidity and interest rates in the global markets. Furthermore, higher domestic interest rates coupled with stable growth rate had created a lower risk perception that attracted higher capital flows. Net capital flows as percentage of GDP increased from 2.2% in 1990-91 to around 9.0% in 2007-08. However, if we see gross capital inflows as a percentage of GDP, then it increased from around 7.2% in 1990-91 to around 36.6% in 2007-08. While capital outflows as a percentage of GDP increased from 5% in 1990-91 to around 27.4% in 2007-08. Most of the capital outflows were on account of FII portfolio transactions, Indian investment abroad and repayment of ECBs. All this has offset a lot of increase in capital inflows. However, India has large excess of capital flows over the amount required to finance current account deficit and that resulted in accretion of foreign exchanges reserves to the tune of around US$308 billion by July 2008. During the period of this systemic sudden decline in capital inflows, the domestic financial system also suffered from risk aversion. Cost of capital spiked up and capital market with good business fundamental suddenly lost access to capital, turning them into non performing borrowers in the banking system. The added to banks’ risk aversion. Bank
credit growth decelerated sharply. Private corporate capex to GDP declined to 12.7% of GDP in 2008-09 from 16.1% of GDP in 2007-08. Discretionary private consumption also suffered. During the crisis year of 2008-09, net capital flows plummeted to USD 6.8 (0.5 per cent of GDP) from USD 106.06 billion (8.7 per cent of GDP in 2007-08. The net capital flows again surged to USD 53.6 billion (4.1 per cent of GDP) during 2009-10.

**COMPOSITION**

The composition of capital flows has undergone a complete change from official debt flows to non debt flows as a result of thrust of policy reform after the balance of payment crisis in 1990s that encouraged non debt creating flows instead of short term debt flows. The official flows got replaced by private equity and external commercial borrowings (ECBs)22. Non debt flows, particularly private foreign investments witnessed a significant rise. The composition of capital inflow has changed significantly over the years. Dependence on aid has vanished and foreign direct investment (FDI), foreign portfolio investment (FPI), external commercial borrowings (ECB) and nonresident Indians (NRI) deposits dominate the capital flows. Among these again, there has been a gradual shift away from debt components to equity flows (The proportion of non-debt has gone up from about 5% in the second half of the 1980). But, the period of 1990s show a radical transformation in the nature of capital flow into India. From a mere absence of any capital flow till 1992 (expect those by Non Residents Indian), today such inflows represent a dominant proportion to total flows. The official flows shows an external assistance, i.e. grants and loans from bilateral and multilateral sources represented 75-80 percent flow till 1991. By 1994, this has come down to about 20 percent and has further fallen to below by 5 percent by late 1990’s. About 460 FII’s have been allowed to enter the Indian market and together have brought in more than US $ 14 billion GDR23 and ADR24 floated by Indian corporate sector brought in the remaining portfolio inflows. By the end of year 2004, India has attracted more than US $ 40 billion of foreign investment (table 1.2):

<table>
<thead>
<tr>
<th>Year</th>
<th>FDI</th>
<th>FPI</th>
<th>FII</th>
<th>NRI</th>
<th>GDR/ADR</th>
<th>Offshore funds and Others</th>
</tr>
</thead>
<tbody>
<tr>
<td>1990-91</td>
<td>97</td>
<td>6</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
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<tr>
<td>1991-92</td>
<td>129</td>
<td>4</td>
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<td>244</td>
<td>1</td>
<td>42</td>
<td>240</td>
<td>-</td>
</tr>
<tr>
<td>1993-94</td>
<td>586</td>
<td>3567</td>
<td>1665</td>
<td>89</td>
<td>1520</td>
<td>-</td>
</tr>
<tr>
<td>1994-95</td>
<td>1314</td>
<td>3824</td>
<td>1503</td>
<td>171</td>
<td>2082</td>
<td>-</td>
</tr>
<tr>
<td>1995-96</td>
<td>2144</td>
<td>2748</td>
<td>2009</td>
<td>169</td>
<td>683</td>
<td>56</td>
</tr>
<tr>
<td>1996-97</td>
<td>2821</td>
<td>3312</td>
<td>1926</td>
<td>135</td>
<td>1366</td>
<td>20</td>
</tr>
<tr>
<td>1997-98</td>
<td>3557</td>
<td>1828</td>
<td>979</td>
<td>202</td>
<td>645</td>
<td>204</td>
</tr>
<tr>
<td>Year</td>
<td>2462</td>
<td>-61</td>
<td>-390</td>
<td>179</td>
<td>270</td>
<td>59</td>
</tr>
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<tr>
<td>1998-99</td>
<td>2155</td>
<td>3026</td>
<td>2135</td>
<td>171</td>
<td>768</td>
<td>123</td>
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<tr>
<td>1999-00</td>
<td>4029</td>
<td>2760</td>
<td>1847</td>
<td>67</td>
<td>831</td>
<td>82</td>
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<tr>
<td>2000-01</td>
<td>6130</td>
<td>2021</td>
<td>1505</td>
<td>35</td>
<td>477</td>
<td>39</td>
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<td>2001-02</td>
<td>5035</td>
<td>979</td>
<td>377</td>
<td>NA</td>
<td>600</td>
<td>2</td>
</tr>
<tr>
<td>2002-03</td>
<td>4322</td>
<td>11377</td>
<td>10918</td>
<td>NA</td>
<td>459</td>
<td>-</td>
</tr>
<tr>
<td>2003-04</td>
<td>6051</td>
<td>9315</td>
<td>8686</td>
<td>NA</td>
<td>613</td>
<td>16</td>
</tr>
<tr>
<td>2004-05</td>
<td>8961</td>
<td>12494</td>
<td>9926</td>
<td>NA</td>
<td>2552</td>
<td>14</td>
</tr>
<tr>
<td>2005-06</td>
<td>22826</td>
<td>7003</td>
<td>3225</td>
<td>NA</td>
<td>3776</td>
<td>2</td>
</tr>
<tr>
<td>2006-07</td>
<td>34835</td>
<td>27271</td>
<td>20328</td>
<td>NA</td>
<td>6645</td>
<td>298</td>
</tr>
<tr>
<td>2007-08</td>
<td>35180</td>
<td>-13855</td>
<td>-15017</td>
<td>NA</td>
<td>1162</td>
<td>-</td>
</tr>
<tr>
<td>2008-09</td>
<td>37182</td>
<td>32375</td>
<td>29047</td>
<td>NA</td>
<td>3328</td>
<td>-</td>
</tr>
<tr>
<td>2009-10</td>
<td>7557</td>
<td>13767</td>
<td>12289</td>
<td>NA</td>
<td>1478</td>
<td>-</td>
</tr>
</tbody>
</table>

Note: FII, NRI, and GDR are introduced in September 1992 and annual data before the 1993 are not available and monthly data are available only from April 1995.

Source: Hand Book of Statistics, Reserve Bank of India (RBI)

Foreign capital inflows were highly volatile in the 2004-05 fiscal. However net inflow was almost same as 2003-04. But in next three years net capital inflows were increased significantly. In the year 2007-08, FDI reached at $ 32435 million. FPI and FII, which were at slide in the year 2006-07, reported a significant increase in the year 2007-08. In the fiscal year of 2006-2007, FDI inflows reported sharp and significant increase. Although FDI inflows are affected by when mega projects come into, the inflows between 2006 and 2007 based on the fiscal year show approximately 200% of growth that is compared to the previous year [U.S.A, U.K and Singapore hold 62% of the FDI inflows. These countries have much higher inflows of FDI in comparison with other countries. Moreover, U.S.A has been interested in entry of Wal-Mart in India and Nuclear Agreement. U.S.A continuously has made a contribution to not only IT industry but also large number of entities in U.S is going to invest in the service sector afterwards. During the crisis ridden year of 2008 to 2009, foreign institutional investors pulled out $9.77 billion of portfolio investment from Indian equity markets. Yet they have been quick to return in 2010. In just the first four months of the fiscal year, they have nearly made up for the exit, reinvesting 87% of the amount they pulled out (CLSA Asia-Pacific Markets). But while this might be interpreted as a revival of confidence in the Indian market, this segment of capital inflows, along with short-term foreign currency borrowings of Indian banks, represents the most volatile component of capital inflows into India. From the table it is revealed that among the components of capital flows, India prefer long term flows to short term flows and non debt flows to debt flows. The logic for that is self evident. India’s policy for the equity flows has been quite liberal, and in sharp contrast to other emerging market economies which liberalized and then reversed the liberalization when flows became volatile, India’s policy has been quite stable.
DETERMINANTS OF FOREIGN CAPITAL INFLOWS IN INDIA

The factors that encourage or hinder international flows of capital can be categorized into those that are external to the economies receiving the flow and the factors internal to those economies. For small open economies, fluctuations in the world interest rates are a key factor inducing capital flows. Other external factors include terms of trade developments, the international business cycle and its impact on profit opportunities and any regulatory changes that affect the international diversification of investment portfolio at the main financial centers. Internal factors are most often related to domestic policy. For example, effective inflation stabilization programs can reduce macroeconomic risk and capital inflows. A similar outcome could result from the introduction of institutional reforms, such as the liberalization of the domestic capital market (Obstfeld, 1986) and the opening of trade account (Calvo, 1999) and policies that result in credible increases in the rate of return on investment (such as tax credits). As the experience of various Latin American countries in the late 1970s shows, domestic policies may also attract speculative capital when policies may also attract speculative capital when policies are not fully credible often partial credibility of these policies leads to relatively high returns on short term assets, which attract foreign capital on grounds of intertemporal speculation. Several of these factors and trends interacted in the early 1990s to make developing countries of Latin America and Asia fertile territory for the renewal of foreign lending.

First, there was a sustained decline in world interest rates. For example, short term interest rates in the United States were declining steadily in the early 1990s, and by late 1992 they were at their lowest level since the early 1960s. Lower interest rates in the developed nations attracted investors to the high-investment yields and improving economic prospects of economies in Asia and Latin America. Given the high external debt burden of many of these countries, low world interest rates also appear to have improved the creditworthiness of debtor countries that borrow at these rates (Fernandez-Arias, 1993). The improved creditworthiness and reduced default risk is reflected in the marked rise in secondary market prices of bank claims on most of the heavily indebted countries through February 1994. While this turn of events was heralded as good news in most developing countries, policymakers there during the early 1990s became concerned about the sustainability of this favorable interest rate environment. Second, the early 1990s brought recessions to the United States, Japan and many countries of Europe. This swing of the international business cycle doubtless made profit opportunities in developing countries appear relatively more attractive. However, as the OECD economies move toward recovery in the mid-1990s, this factor will become less important in generating capital flows to Latin America and Asia. Third, there has been a trend toward international diversification of investments in major financial centers and toward growing integration of world capital markets (Gooptu, 1993). Increasing amounts of funds managed by life insurance companies and mutual funds have entered emerging markets. Regulatory changes in the United States and Europe have also made it easier for foreign firms to
place their equity and bonds under more attractive conditions to investors (Bercuson and Linda, 1993). Fourth, many heavily indebted countries made significant progress toward improving relations with external creditors. Other domestic policies that could be added to this list include the role played by debt equity swaps in encouraging foreign direct investment (Edwards, 1991). Fifth, several countries began to adopt sound monetary and fiscal policies as well as market-oriented reforms that has included trade and capital market liberalization. For example Bolivia, Chile and Mexico implemented major disinflation programs in the late 1980s, while Argentina, Brazil, Ecuador and Peru have done so during the early 1990s. An effective inflation stabilization program can reduce macroeconomic risks and stimulate capital inflows. A similar outcome could result from the introduction of institutional reforms, such as the liberalization of the domestic capital market (Obstfield, 1986) and the opening of the trade account (Calvo, 19880 and policies that result in credible increases in the rate of return on investment (such as tax credits).

Finally, a large shift in capital flows to one or two large countries in a region may generate externalities for the smaller neighboring countries. These are the so-called contagion effects. for example, it could be argued that Mexico’s and Chile’s reentry into international capital markets in 1990 made investors more familiar and more willing to invest emerging markets in Latin America. Indeed, the more recent events suggest that the Mexican crisis of late 1994 tended to make the attitude of investors toward emerging markets more discriminating. Thus, foreign capital flow is affected by a number of factors. These factors depend on the nature of foreign capital. To study these factors in a systematic manner, it is imperative to understand the determinants of FDI and FPI separately.

DETERMINANTS OF FDI:

Nowadays, virtually all countries are actively seeking to attract FDI, because of the expected favorable effect on income generation from capital inflows, advanced technology, management skills and market know-how. It would be useful to review the key determinants and factors of FDI based on the theories of international investment. There has been extensive research on the determinants of FDI. In general, the decision to invest abroad is taken by transnational companies (TNCs) if they can combine their ownership-specific advantages with the location-specific advantages of host countries through internalization i.e. through intra-firm rather than arm’s length transactions. Three broad factors determine the location of FDI: the policies of host countries, the proactive measures countries adopt to promote and facilitate investment, and the characteristics of their economies. Table 1.4 lists three key determinants and factors associated with the extent and pattern of FDI in developing host countries: attractiveness of the economic conditions in host countries; the policy framework towards the private sector, trade and industry, and FDI and its implementation by host governments; and the investment strategies of MNEs.

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

**Table 1.3: Host Country Determinants of Foreign Direct Investment**

<table>
<thead>
<tr>
<th>Economic conditions</th>
<th>Market</th>
<th>Size; income levels; urbanization; stability and growth prospects; access to regional markets; distribution and demand patterns.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Resources</td>
<td>Natural resources; location.</td>
</tr>
<tr>
<td></td>
<td>Competitiveness</td>
<td>Labour availability, cost, skills, trainability; managerial technical skills; access to inputs; physical infrastructure; supplier base; technology support.</td>
</tr>
<tr>
<td>Host country policies</td>
<td>Macro Policies</td>
<td>Management of crucial macro variables; ease of remittance; access to foreign exchange.</td>
</tr>
<tr>
<td></td>
<td>Private sector</td>
<td>Promotion of private ownership; clear and stable policies; easy entry/exit policies; efficient financial markets; other support.</td>
</tr>
<tr>
<td></td>
<td>Trade and industry</td>
<td>Trade strategy; regional integration and access to markets; ownership controls; competition policies; support for SMEs.</td>
</tr>
<tr>
<td></td>
<td>FDI policies</td>
<td>Ease of entry; ownership, incentives; access to inputs; transparent and stable policies.</td>
</tr>
<tr>
<td>MNE strategies</td>
<td>Risk perception</td>
<td>Perceptions of country risk, based on political factors, macro management, labour markets, policy stability.</td>
</tr>
<tr>
<td></td>
<td>Location sourcing, integration transfer</td>
<td>Companies strategies on Location, sourcing of products/inputs, integration of affiliates, strategic alliances, training,</td>
</tr>
</tbody>
</table>


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

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

The pattern of recent FDI flows supports the conclusion that liberal policies on technology, which tend to go hand in hand with more liberal policies in general, serve to attract more and better foreign investments. Core FDI policies consist of rules and regulations governing the entry and operations of foreign investors, the standards of treatment accorded to them and functioning of the markets within which they operate (UNCTAD, 1999). Among the supplementary policies used to influence locational decisions, trade policy plays the most prominent role. Asian countries have used both FDI and trade policies to encourage MNEs to contribute to their export-oriented development strategies. Other related policies may include privatization policies and policies determined by international agreements, such as bilateral investment treaties (BITs). BITs augment the international dimension to national direct investment policies focused on insurance and protection and other broader issues. However, as in the case of BITs, it is precisely the function of the enabling framework to allow other determinants, especially economic determinants, to assert their influence.

**DETERMINANTS OF FPI:**

Whereas FDI determinants are well researched, the determinants driving portfolio investors are more complex, involving the interactions of factors related to external environment, investors’ strategies and specific host country determinants.

As many developing countries and countries in transition have embarked on a process of investors were able to allocate their savings has grown substantially over the last ten years. In parallel, the tremendous growth of investible assets managed by institutional investors in OECD countries has flooded international capital markets with liquidity. For example in 1998, the total net assets of OECD pension funds were estimated at around 11 trillion US$ (14% of which were cross-border investment), while total assets of mutual funds in the world exceeded 8 trillion US$ (with US funds
alone accounting for more than 5 trillion US$). Accompanied by rapid financial innovation, the combination of these events produced change in investor strategies as well as a re-allocation of funds towards emerging markets.

There are two key factors which explain the increased interest, until the Asian crisis, of international investors towards emerging markets as a group: potentially higher returns and the benefits of diversification. Once the decision is taken to invest in emerging markets, some host country determinants are of critical importance for fixed income investors and are of minor importance to equity investors and vice-versa.

**Host country determinants:** Determinants of FPI can be put into two groups: economic determinants and policy/regulatory determinants. Economic determinants are not directly linked to policies aimed at attracting foreign portfolio flows. Instead, they are a reflection of the general health of the economy, the potential for the firms operating in such a business environment to earn profits, and to obtain a satisfactory return on fixed income investment. Investors will typically focus on the following factors:

- **High economic growth rate**
- **Exchange rate stability**
- **Macroeconomic stability**
- **Level of foreign exchange reserves**
- **Health of domestic banking system**
- **Stock and bond market liquidity**
- **Real interest rates.**

Some of the above factors will be of more importance to equity investors and others to fixed income investors. For example, high economic growth rates and the liquidity of the stock market will be of particular importance to portfolio managers specializing in equity investments. On the other hand, the degree of bond market liquidity and the level of real interest rates will be of particular importance for fixed income investors.

Although the amount of portfolio capital invested in emerging markets has increased countries which are associated with sound macro-economic policies and relatively high growth rates. Thus, Africa which continues to have uncertain growth prospect, received less than one per cent of total equity assets invested in emerging markets. Even in Asia, which accounted for over a half of cumulative foreign portfolio investment between 1990 and 1997, a few countries account for the quasi-totality of such inflows. The other set of determinants of which foreign investors pay particular attention includes policy and regulatory frameworks in individual emerging markets. These are the factors over which domestic governments have a direct influence. The main determinants in this group are the following:

- **Ease of repairing dividends and capital**
- **Domestic capital gains tax**
- **Stock and bond market regulation**
- **Quality of domestic accounting disclosure standards**
• Speed and reliability of settlement system
• Availability of domestic custodians and brokers
• Degree of investor rights protection.

It is not possible to isolate any single factor as being the most important, although some tend to carry more weight than others. For example, the degree of investor rights protection and the ease of repatriating dividends and capital are often cited as being closely watched by potential investors.

Some governments have used very innovative ways to promote foreign portfolio investment and to facilitate the access of their companies to international finance. For example, as the country moves along the path of liberalization and the opening of capital markets, the government of Mexican corporate bonds in international markets. The logic behind this move stems from the fact that corporate bonds across the maturity spectrum are priced in direct relation to sovereign debt, according to the perceived risk of each company relative to the sovereign risk. By issuing government bonds of various maturities, the international market was able to price the sovereign debt, and by using the risk premium of each company relative to the sovereign risk, corporate debt could be also be priced easily. The move by the Mexican government was widely welcomed by the international investment community as it increased the transparency of pricing corporate debt. In parallel, this policy the way for corporate issuers to access the international investors would be ready to lend those funds for various lengths of time.

VOLATILITY IN CAPITAL FLOWS

Volatility of capital flows is characterized by the high frequency of reversibility of flows or by a high variability in the volume of capital inflows. Reversibility and variability result from the fact that capital flows are highly sensitive to changes in their determinants. Volatility of capital flows can create and unstable investment environment detrimental to growth and development. There are many channels through which volatility exert a negative impact on economy. The first is through unexpected changes in the availability of finance, and consequential changes in its cost and in asset prices. This will induce high variability in expected profits, making difficult investment planning. The second is through the effect of compensatory adjustment in monetary, fiscal and exchange rate policies in the face of rapid changes in the availability of external finance. And finally, capital volatility has an impact on consumption and consequently on growth. On account of such a boom and bust pattern, since the mid 1990s many EMEs and regions-Mexico in 1994-95, Asia in 1997, Russia in 1998, Argentina in 2001, and Emerging Europe in the ongoing financial crisis-have suffered financial crises. “Financial crises are more frequent than most people think, and they lead to losses that are much larger than one would hope. On average, there have been between three and four systemic banking crises per year for the past quarter century” (Cecchetti and Upper, 2009). In a sample of 40 financial crises, these authors found that fully one fourth resulted in cumulative output
losses of more than 25 per cent of pre-crisis GDP. And one third of the crisis-related contractions lasted for three years or more. Whereas crises in the recent past have largely been associated with EMEs and developing countries, the current crisis is that of advanced countries. In their case also, it is the expansion of global financial imbalances that has been among the major causes.

Thus, capital flows such as direct and portfolio are most helpful only when the magnitude of those flows is steady and stable. If the capital flows are volatile or temporary, the country would have to go through an adjustment process in both the real and financial markets. Capital inflows, which come in the form of foreign direct investment (FDI), are generally considered more permanent and stable in character. Both Net portfolio flows and banking flows are volatile. So, it is said that FDI is in general less volatile than FPI. FDI is made in recipient countries through the establishment of production lines which would be difficult to dissolve in a short time therefore, disinvestment or reversibility is much more difficult to undertake than in the case of portfolio investment, which can be easily sold off on financial markets.

The instability of capital inflows may retard economic growth and structural development, when there is a sudden increase in real exchange rate inflationary pressures and deterioration in current account, but the sudden and sharp withdrawal of capital inflows could push the country into insolvency or drastically lower the productivity of existing capital stocks. Both excess and sharp withdrawal (siphoning-off) of capital inflows is harmful for an economy. But slowdown or slowly decline in capital inflows is more harmful than an increase in capital inflows. India has experienced both floods and sudden stop of capital flows. Net capital flows to Indian increased from as low as US$ 7 billion in 1990-91 to US$ 45 billion in 2006-07, and further to US$ 107 billion during 2007-08 the year just before the crisis. They slipped to as low as US $ 7 billion in 2008-09 at the height of the crisis. Capital flows are estimated to have recovered to around US$ 50 billion in 2009-10.

**Siphoning-off of Capital Flows**

That emerging markets frequently lose access to international capital markets during times of crisis has by now been well documented empirically (Calvo and Reinhart, 2000). This phenomenon of a sudden loss of access to capital markets has been termed a “sudden stop” of capital inflows by Calvo (1998) and constitutes the core subject of study in this study. In the present study it has been titled as “Siphoning-off of Capital Flows**34**”. In the Indian context, it is inappropriate to use the term sudden stops as capital flows in India declined suddenly during the crisis period. Therefore, it is more logical to use the term sudden declines in the Indian context.

While the existence of sudden stops has been recently recognized empirically and their prevention has come to occupy the thoughts of policy makers (Bordo 2003, IMF 1999, 2000, and 2001, Williamson 2002 and Wolf 2003 for a few examples), the theoretical underpinnings needed to better inform both policy making and empirical study are still in a state of flux (Ball, 2002). According to the empirical literature
(Calvo et al., 2006), the probability of a sudden stop increases with the current account deficit and foreign currency-denominated debt (where the latter may be impaired substantially by a real exchange rate depreciation). Sudden stop of capital inflows has a harmful impact on an economy. When there is a sudden decline in capital inflows then it will lead to economy into insolvency and affect many macroeconomic variables like exchange rates, interest rates, foreign exchange reserves and domestic monetary conditions etc. When there is sudden reversal of capital inflows then it reduces the growth rate of an economy, increases the interest rates and depreciates the currency and others. The impact of global crisis is still in existence in India and might create more difficulties for the Indian economy warranting a more cautious approach on fiscal and monetary aspects. According to Prime Minister Dr. Man Mohan Singh “the economic slowdown is a challenge before the country. World is affected by economic slowdown. We are also affected as the world economy is interlinked”. The global financial crisis has hit India through a sudden stop of capital inflows (Joseph, 2009) and a collapse of both external and domestic demand. Therefore, the causes and consequences of slowdown of capital inflows are necessary to find and after that it is necessary to adopt the adequate policy option to come out the effect of reversal of capital inflows.

CONCLUSION

Foreign capital has a key role to play in the economic development of India. There are several ways in which capital flows and economic growth are related. However, impact of capital flows on economic growth ultimately depends on their being stable and less volatile. Indian government has been continuously proceeding for economic reforms and is quiet assured to secure legislation to allow more foreign investment in various sectors. The size of net capital inflows to India has increased significantly in the post reform period. It is also important to note that capital inflows increased extensively since 2005. However, capital inflows declined during 2007-08 to 2008-09 as a consequence of global financial crisis. The movement of capital inflows clearly indicates that capital inflows in India are highly volatile. In fact, India has experienced both sudden increase and sudden declines of capital flows. Various studies explored that both excess and sudden declines (siphoning-off) of capital inflows are harmful for an economy. But sudden declines in capital inflows are more harmful as sudden declines of capital inflows may lead any economy into insolvency and affect the various macroeconomic variables. Therefore, effective buttressing of these capital inflows is a key economic policy issue today. Countries with sound macroeconomic policies and well-functioning institutions are in the best position to reap the benefits of capital flows and minimize the risks. India's inability to deal with capital inflows is partly a result of the government doing less of what it should do more of, and doing more of what it should do less of. There is precious little in terms of economic reforms, but the government has gone to great lengths to encourage more capital inflows.
A transition country or transitional economy is an economy which is changing from a centrally planned economy to a free market. Transition economies undergo economic liberalization (letting market forces set prices and lowering trade barriers), macroeconomic stabilization where immediate high inflation is brought under control, and restructuring and privatization in order to create a financial sector and move from public to private ownership of resources. Capital inflow includes Foreign Direct Investment (FDI), Foreign Portfolio Investment (FPI), External Commercial Borrowing (ECBs), NRI Deposits and Social Deposits Schemes dominated that capital account.

Developing countries have two options of raising capital. First, by creating capital surplus from internal sources of capital formation such as controlling consumption, reducing, foreign imports and other measures such as taxation, public borrowing, budgetary savings from current revenue and profits of public enterprises. However, due to much rigidity in the internal economy, these measures cannot accumulate much capital and the rate of their accumulation will be more or less static and not flexible. The second method of capital formation is taking foreign assistance of accelerating the rate of internal capital formation in the shortest period of time.

The Millennium Development Goals (MDGs) are eight international development goals that all 192 United Nations member states and at least 23 international organizations have agreed to achieve by the year 2015. They include eradicating extreme poverty, reducing child mortality rates, fighting disease epidemics such as AIDS, and developing a global partnership for development.

Diaz-Alejandro (1983) and Eichengreen (1991) stress the important role played by developments in the major financial centres in affecting the pattern of lending to developing countries.

There is ambiguity in terminology for the different kinds of international capital flows. The same terms used by different institutions or writers often cover different categories of capital transactions, while the same categories are sometimes referred to in different terms. The definitions used throughout this paper are as follows:

**Capital inflow:** This term refers to the acquisition of domestic assets by non-residents (plus grants). Sales of domestic assets are defined as a negative capital inflow. Thus the term net capital inflow denotes acquisition minus sales of domestic assets by non-residents. The types of asset included in these flows vary according to the institution publishing the data. The term net resource flows used by the World Bank in its Global Development Finance, for example, refers to capital transactions by nonresidents, but excludes assets that give rise to short-term debt. In the IMF Balance of Payment Statistics, capital inflows are the items included in the capital and financial accounts of the balance of payments, comprising mainly credit items (such as debt forgiveness and migrants' transfers) under the heading of “capital transfers”, “direct investments” in the country concerned, and the liability items under “portfolio investment” and “other investment” (which includes both short-term and long-term debt in such forms as bank loans, other types of trade credit, and borrowing from IMF).

**Capital outflow:** This term refers to the acquisition of foreign assets by residents. Sales of foreign assets are defined as a negative capital outflow. Thus the term net capital outflow denotes acquisitions minus sales of foreign assets by residents. In the IMF Balance of Payments Statistics, capital outflows consist of the debit items under the heading of “capital transfers”, “direct investment abroad”, and the asset items under “portfolio investment” and “other investment”.

**Net capital flow:** This term refers to total net capital inflow less total net capital outflow as defined above. It is positive when net inflows exceed net outflows. Net transfer: This term refers to net capital inflows less net factor payments abroad; the latter include interest payments on external debt as well as profit remittances. Net transfer is thus a broad measure of a country's capacity to finance its trade deficits.

Economist use the term capital to mean goods used for the further production. In business world, however, capital is always expressed in the terms of money.

FDI up to 100 per cent is allowed under the automatic route in all activities/sectors except where the provisions of the consolidated FDI Policy, paragraph on 'Entry Routes for Investment' issued by the Government of India from time to time, are attracted. FDI in sectors /activities to the extent permitted under the automatic route does not require any prior approval either of the Government or the Reserve Bank of India.
FDI in activities not covered under the automatic route requires prior approval of the Government which are considered by the Foreign Investment Promotion Board (FIPB), Department of Economic Affairs, Ministry of Finance. Application can be made in Form FC-IL, which can be downloaded from http://www.dipp.gov.in. Plain paper applications carrying all relevant details are also accepted. No fee is payable. Indian companies having foreign investment approval through FIPB route do not require any further clearance from the Reserve Bank of India for receiving inward remittance and for the issue of shares to the non-resident investors. The Indian company having received FDI either under the Automatic route or the Government route is required to report in the Advance Reporting Form, the details of the receipt of the amount of consideration for issue of equity instrument viz. shares / fully and mandatorily convertible debentures / fully and mandatorily convertible preference shares through an AD Category –I Bank, together with copy/ies of the FIRC evidencing the receipt of inward remittances along with the Know Your Customer (KYC) report on the non-resident investors from the overseas bank remitting the amount, to the Regional Office concerned of the Reserve Bank of India within 30 days from the date of receipt of inward remittances. Further, the Indian company is required to issue the equity instrument within 180 days, from the date of receipt of inward remittance or debit to NRE/FCNR (B) account in case of NRI/PIO. After issue of shares / fully and mandatorily convertible debentures / fully and mandatorily convertible preference shares, the Indian company has to file the required documents along with Form FC-GPR with the Regional Office concerned of the Reserve Bank of India within 30 days of issue of shares to the non-resident investors.

SEBI acts as the nodal point in the registration of FIIs. The Reserve Bank of India has granted general permission to SEBI Registered FIIs to invest in India under the Portfolio Investment Scheme (PIS).

Investment by SEBI registered FIIs and its sub accounts cannot exceed 10 per cent of the paid up capital of the Indian company. However, in case of foreign corporate or High Networth Individuals (HNIs) registered as sub accounts of an FII, their investment shall be restricted to 5 per cent of the paid up capital of the Indian company. All FIIs and their sub-accounts taken together cannot acquire more than 24 per cent of the paid up capital of an Indian Company. An Indian company can raise the 24 per cent ceiling to the sectoral cap / statutory ceiling, as applicable, by passing a resolution by its Board of Directors followed by passing a Special Resolution to that effect by their General Body. The Indian company has to intimate the raising of the FII limit to the Reserve Bank to enable the Bank to notify the same on its website for larger public dissemination.

FIIs include Asset Management Companies, Pension Funds, Mutual Funds, Investment Trusts as Nominee Companies, Incorporated / Institutional Portfolio Managers or their Power of Attorney holders, University Funds, Endowment Foundations, Charitable Trusts and Charitable Societies.

AMCs offer their clients more diversification because they have a larger pool of resources than the individual investor. Pooling assets together and paying out proportional returns allows investors to avoid minimum investment requirements often required when purchasing securities on their own, as well as the ability to invest in a larger set of securities with a smaller investment.

For effective monitoring of foreign investment ceiling limits, the Reserve Bank has fixed cut-off points that are two percentage points lower than the actual ceilings. The cut-off point, for instance, is fixed at 8 per cent for companies in which NRIs/PIOs can invest up to 10 per cent of the company's paid up capital. The cut-off limit for companies with 24 per cent ceiling is 22 per cent and for companies with 30 per cent ceiling, is 28 per cent and so on. Similarly, the cut-off limit for public sector banks (including State Bank of India) is 18 per cent. Once the aggregate net purchases of equity shares of the company by FIIs/NRIs/PIOs reach the cut-off point, which is 2% below the overall limit, the Reserve Bank cautions all designated bank branches so as not to purchase any more equity shares of the respective company on behalf of FIIs/NRIs/PIOs without prior approval of the Reserve Bank. The link offices are then required to intimate the Reserve Bank about the total number and value of equity shares/convertible debentures of the company they propose to buy on behalf of FIIs/NRIs/PIOs. On receipt of such proposals, the Reserve Bank gives clearances on a first-come-first served basis till such investments in companies reach 10 / 24 / 30 / 40 / 49 per cent limit or the sectoral caps/statutory ceilings as applicable. On reaching the aggregate ceiling limit, the Reserve Bank advises all designated bank branches to stop purchases on behalf of their FIIs/NRIs/PIOs clients. The Reserve Bank also informs the general public about the `caution’ and the ‘stop purchase’ in these companies through a press release.

Following entities / funds are eligible to get registered as FII:
1. Pension Funds
2. Mutual Funds
3. Insurance Companies
4. Investment Trusts
5. Banks
6. University Funds
7. Endowments
8. Foundations
9. Charitable Trusts / Charitable Societies

Further, following entities proposing to invest on behalf of broad based funds, are also eligible to be registered as FIIs:
1. Asset Management Companies
2. Institutional Portfolio Managers
3. Trustees

15 Capital inflows, however, are not an unmitigated blessing. Large capital inflows often are associated with inflationary pressures, a real exchange rate appreciation, and deterioration in the current account. In addition, the history of Latin America provides ample evidence that massive capital inflows also may contribute to stock market bubbles and lead to an excessive expansion in domestic credit, jeopardizing the financial system’s stability. Short term capital inflows intensify these problems as the probability of an abrupt and sudden reversal increases. Not surprisingly, therefore, effective buttressing of these capital inflows is a key economic policy issue today.

16 The eminent business historian Mira Wilkins plainly states that during the 1875-1914 periods, the USA was “the greatest debtor nation in history" despite its rise as one of the major lender countries in the international capital market at the end of this period16 (Wilkins, 1989).

17 Capital surges to emerging markets have typically been part of a larger, periodic process of rapid expansion of the global economy. They occur when the worldwide diffusion of technological changes improves communications and transport, growth is buoyant, world trade is expanding, financial innovation is rapid, and the political climate is supportive.

18 Within the first few years after 1947, the attitude of the Government towards foreign capital changed rapidly. Two documents presented in the immediate post independence period reflect the change. The first document, presented in January 1948 by the Economic Programmes Committee of the Congress Party, the party that was running the Government brought out the antagonism towards foreign capital. But in the next document, the Industrial Policy Statement of Government, presented in April 1948, there were signs of a change in attitude towards foreign capital. The Industrial Policy Statement argued that foreign capital was valuable in bringing resources for development and that it also provided technology and knowledge for rapid industrialization of India.

19 For the first four decades after independence in 1947, the economic policies of the Indian government were characterized by planning, control and regulation. Until the 1980s, India’s development strategy was focused on self-reliance and import substitution. There were periodic attempts at market-oriented reform, usually following balance of payments pressures, which induced policy responses that combined exchange rate depreciation and an easing of restrictions on foreign capital inflows. However, these controls were relatively narrow in scope and had little impact on actual inflows, which remained small. The situation changed dramatically with the onset of reform programmes introduced in the early 1990s in the aftermath of the balance of payments crisis of 1991.

20 Since the 1990s, the broad approach towards permitting foreign direct investment has been through a dual route, i.e. automatic and discretionary, with the ambit of the automatic route being progressively enlarged to almost all the sectors, coupled with higher sectoral caps stipulated for such investments. Portfolio investments are restricted to institutional investors. The approach to external commercial borrowings has been one of prudence, with self-imposed ceilings on approvals and a careful monitoring of the cost of raising funds as well as their end use. In respect of NRI deposits, some modulation of inflows is exercised through specification of interest rate ceilings and maturity requirements. In respect of capital outflows, the approach has been to facilitate direct overseas investment through joint ventures and wholly owned subsidiaries, and through the provision of financial support to exports, especially project exports from India. Ceilings on such outflows have been substantially liberalized over time. The limits on remittances by domestic individuals have also been eased. With the progressive opening-up since the early 1990s, the capital account in India today can be considered as the most liberalized it has ever been since the late 1950s.

21 Indian economy has reached to a landmark of 9% GDP in 2007-08. Robust agricultural sector has pushed the GDP to 9% even when the manufacturing sector fails to live up the expectations of higher growth. The economy has boomed at 9 per cent in 2007-08, more than 8.7% what was estimated. The time period from 2003-04 to 2007-08 has seen a 5 progressive years in the India's economy history
with a 8.8% annual average GDP growth rate. The 2007-08 9% GDP has put India into the group of one of the fastest growing major economy after China. It is the 3rd year in a row, in which nation's GDP has touched the mark of 9% or above.

22 External Commercial borrowing (ECB) is a term used to refer to commercial loans availed from non-resident lenders with a minimum average maturity of 3 years in the form of bank loans, buyers credit, suppliers credit, securitized instruments (e.g. floating rate notes and fixed rate bonds). A company is free to raise ECB from any internationally recognized source such as banks, export credit agencies, suppliers of equipment, foreign collaborators, foreign equity-holders, international capital markets etc. However, offers from unrecognized sources are not entertained. ECB can be accessed under two routes, Automatic Route and Approval Route. Under the Automatic Route, the approval of Reserve Bank of India (RBI) or the Governments approval are not required. However, in case of doubt regarding eligibility under the Automatic Route, applicants may take recourse to the Approval Route. The maximum amount of ECB that can be raised by an eligible borrower under the Automatic Route during one financial year is USD 500 million. NGOs engaged in micro finance activities have been permitted to raise ECB up to USD 5 million during a financial year for permitted end-use.

23 A bank certificate issued in more than one country for shares in a foreign company. The shares are held by a foreign branch of an international bank. The shares trade as domestic shares, but are offered for sale globally through the various bank branches.

24 An American Depositary Receipt (abbreviated ADR) represents ownership in the shares of a non-U.S. company that trades in U.S. financial markets. The stock of many non-US companies trade on US stock exchanges through the use of ADRs. ADRs enable U.S. investors to buy shares in foreign companies without the hazards or inconveniences of cross-border & cross-currency transactions. ADRs carry prices in US dollars, pay dividends in US dollars, and can be traded like the shares of US-based companies.

25 Over a time horizon of the early 1990s, the effect does not necessarily depend on the credibility of these stabilization programs. As the experience of various Latin American countries in the late 1970s shows, domestic policies may also attract speculative capital when policies are not fully credible. Often the partial credibility of these policies leads to relatively high returns on short-term assets, which attract foreign capital on grounds of intertemporal speculation.

26 The world investment report 1998 in chapter IV contained a detailed analysis of FDI determinants. Discussion in the present report summarizes this analysis.

27 See host country determinants as included in the UNCTAD questionnaire, reported in the appendix.

28 China, Hong Kong SAR, Singapore, Malaysia, the Philippines, Thailand and Indonesia.

29 Reversals of capital flows to the EMEs are often quick, as again shown by the current financial crisis, necessitating a painful adjustment in bank credit, collapse of asset prices, compression of domestic demand and output losses. Thus, the boom and bust pattern of capital inflows can, unless managed proactively, result in large employment and output losses, and macroeconomic and financial instability.

30 The root causes of the crisis are usually attributed to Salinas de Gortari's policy decisions while in office, which ultimately strained the nation's finances. As in prior election cycles, a pre-election disposition to stimulate the economy, temporarily and unsustainably, led to post-election economic instability. There were concerns about the level and quality of credit extended by banks during the preceding low-interest rate period, as well as the standards for extending credit. The country's risk premium was affected by an armed rebellion in Chiapas, causing investors to be wary of investing their money in an unstable region. The Mexican government's finances and cash availability were further hampered by two decades of increasing spending, a period of hyperinflation from 1985 to 1993, debt loads, and low oil prices. Its ability to absorb shocks was hampered by its commitments to finance past spending.

31 Also called the “Asian Contagion”, this was a series of currency devaluations and other events that spread through many Asian markets beginning in the summer of 1997. The currency markets first failed in Thailand as the result of the government's decision to no longer peg the local currency to the U.S. dollar. Currency declines spread rapidly throughout South Asia, in turn causing stock market declines, reduced import revenues and even government upheaval.

32 The Russian financial crisis (also called "Ruble crisis") hit Russia on 17 August 1998. It was triggered by the Asian financial crisis, which started in July 1997. During the ensuing decline in world commodity prices, countries heavily dependent on the export of raw materials were among those most severely hit. Petroleum, natural gas, metals, and timber accounted for more than 80% of Russian exports, leaving the country vulnerable to swings in world prices. Oil was also a major source of government tax revenue.
The Argentine economic crisis was a financial situation that affected Argentina’s economy during the late 1990s and early 2000s. Macro economically speaking, the critical period started with the decrease of real GDP in 1999 and ended in 2002 with the return to GDP growth, but the origins of the collapse of Argentina’s economy, and their effects on the population, can be found in action before.

A sudden stop, or a capital account crisis, can be defined as a large and largely unexpected fall in capital inflows occurring in conjunction with a sharp rise in credit spreads (Calvo et al., 2006, Mendoza, 2008, and Chamon et al., 2006). Such a scenario is generally associated with a sharp depreciation of the currency and an abrupt collapse in aggregate demand. Output falls and unemployment rises substantially. This is what the Icelandic economy is experiencing now. While the macroeconomic consequences of sudden stops are generally very similar, the causes can vary, as can the factors triggering the crisis.

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