

**NTCC PROJECT**

**ON**

**COMPARITIVE STUDY OF FOREIGN EXCHANGE INFLOWS IN INDIA.**

**SUBMITTED BY-**

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**Index**

|  |  |
| --- | --- |
| **1.** | **Acknowledgment** |
| **2.** | **Introduction** |
| **3.** | **Rational behind studying** |
| **4.** | **Review of literature** |
| **5.** | **FDI trends in India** |
| **6.** | **Sectoral investments by FDI in India.** |
| **7.** | **Impact of FDI on economic indicators in India** |
| **8.** | **Conclusion** |
| **9.** | **References and bibilography** |

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1. **Introduction**

Foreign Direct Investment (FDI) is an investment directly into production and services in a country by a company located in another country, either by buying a company or by expanding business in that country. It is another mode of doing business in a foreign country.

When foreign enterprises enter into competition with local firms, the latter are forced to improve their technology, quality and management. FDI is treated as an important mechanism for channelizing transfer of capital and technology and thus perceived to be a potent factor in promoting economic growth in host countries.

Moreover, MNCs consider FDI as an important mean to reorganize their production activities across borders in accordance with their corporate strategies and the competitive advantage of host countries.

After the economic reforms in 1991, India has liberalized the foreign direct investment (FDI) policy. Number of measures have been taken to promote FDI, thus government of India has been succeeded in attracting more FDI in India.

From the year 1991-1992to 2011-12, India has fetched 4,26,318 US $ million FDI inflows (considering estimates made by RBI for the year 2010 to 2012). According to UN report, India is the third most favored destination for investment after China and the US for major global companies.

India needs foreign capital due to inadequate domestic capital and also for economic development. FDI is generally known to be the most stable component of capital flows needed to finance the current account deficit. India has become an investment hub over last decade. The major areas of FDIs are- oil, mining, coal and gas, banking, insurance, transportation, finance, manufacturing, retailing etc. FDI is significant to India as an engine of growth.

1. **Rational behind studying**

Since the beginning of liberalization FDI flows to India have steadily grown in importance. Foreign capital flows have come to be acknowledged as one of the important sources of funds for economies that would like to grow at a rate higher than what their domestic savings can support. This resulted in the integration of global financial markets. As a result, capital started flowing freely across national borders seeking out the highest rate of return. India is considered as a good investment option by world investors in spite of political differences and lack of infrastructure facility etc. Indian market presents vast potential and alluring and encouraging foreign investors continuously. The FDI flows were close to $15bn in the last three months of 2009. However the SEBI statistics reveal that the FDIs are seen as the net sellers in the Indian markets, they sold securities worth Rs 7236.8 crores since 2008. On January 21 2008, BSE Sensex saw the largest ever fall in record, BSE shack by 2000 points intra-day. In this regard everyone’s query is whether the FDI positions have caused Indian markets as we see most often vice –versa.

Foreign portfolio inflows through FDIs, in India, are important from the policy perspective, especially when the country has emerged as one of the most attractive investment destinations in Asia. This paper reveals if the FDIs influence the Indian Equity Market. The present study also focuses on their investment pattern in the Indian stock market. It examines the factors expected to affect the investment decisions of FDI’s. The Foreign Institutional Investors (FDIs) have emerged as important players in the Indian equity market in the recent past. This paper makes an attempt to understand whether there exists a relationship between FDI and Equity Market returns in India.

1. **Review of literature**

**Andersen P.S and Hainaut P. (2004)** in their paper *“Foreign Direct Investment and Employment in the Industrial Countries”* point out that while looking for evidence regarding a possible relationship between foreign direct investment and employment, in particular between outflows and employment in the source countries in response to outflows. They also find that high labour costs encourage outflows and discourage inflows and that such effect can be reinforced by exchange rate movements. The distribution of FDI towards services also suggests that a large proportion of foreign investment is undertaken with the purpose of expanding sales and improving the distribution of exports produced in the source countries. According to this study the principle determinants of FDI flows are prior trade patterns, IT related investments and the scopes for cross –border mergers and acquisitions. Finally, the authors find clear evidence that outflows complement rather than substitute for exports and thus help to protect rather than destroy jobs.

**Kulwantraj N. Bindu (2004),** in his research paper titled *‘A study on the determinants of foreign Institutional Investments in India and the role of risk, inflation and return’* had conducted an intensive study to find out the determinants responsible for the flow of FDIs and their degree of impact. With the help of monthly data they found out that FDI inflow depends on stock market returns, inflation rates (both domestic and foreign), and ex-ante risk. In terms of magnitude, the impact of stock market returns and the ex-ante risk turned out to be the major determinants of FDI inflow. The study has not found any causative link running from FDI inflow to stock returns.

**Raj Chaitanya (2003),** in his research work titled *‘Foreign Institutional Investments’* discussed in length about the FDIs and their impact on the Indian economy. Analyzing daily flow data, he concludes that the stock market performance has been the sole driver of FDI flows, though monthly data in the pre-Asian crisis period suggests some reverse causality.

**Klaus E Meyer (2005),** in his paper *“Foreign Direct investment in Emerging Economies”* focuses on the impact of FDI on host economies and on policy and managerial implications arising from this (potential) impact. The study finds out that as emerging economies integrate into the global economies international trade and investment will continue to accelerate. MNEs will continue to act as pivotal interface between domestic and international markets and their relative importance may even increase further. The extensive and variety interaction of MNEs with their host societies may tempt policy makers to micro –manage inwards foreign investment and to target their instruments at attracting very specific types of projects. Yet, the potential impact is hard to evaluate ex ante (or even ex post) and it is not clear if policy instruments would be effective in attracting specifically the investors that would generate the desired impact. The study concluded that the first priority should be on enhancing the general institutional framework such as to enhance the efficiency of markets, the effectiveness of the public sector administration and the availability of infrastructure. On that basis, then, carefully designed but flexible schemes of promoting new industries may further enhance the chances of developing internationally competitive business clusters.

**Krishna Reddy Chittedi(2009),**in his research work titled *‘Volatility of Indian Stock Market and FDIs’* analyzed the performance of sensex v/s. FDIs and some of the most talked about movements of the sensex, starting with the secondary market summary of each year. Foreign investments in BSE reveal that the liquidity as well as volatility was highly influenced by the FDI flows. FDIs are significant factor in determining the liquidity and volatility in the stock prices. With thorough analysis regarding the stock market in last 2 years, it was concluded that stock market touched its peak at 21000 but then crashed badly.

**Trivedi and Nair (2005),** in their study examined the volume of foreign investment and profit booking in Indian market and thereby suggested that, given the huge volume of investments, the foreign investors can play as market makers and book their gains. They can also buy financial assets when the prices are declining and sell when the asset prices are increasing. Hence there may exist a bi-directional relationship b/w FDI and equity stock-returns.

**Bhupender Singh(2005),**in his research work titled *‘Inter-Relation Between FDI, Inflation and Exchange Rate’* discussed about as to how the financial sector of an economy plays a vital role in attracting the Foreign Institutional Investment inflows. The study tries to examine the extent of effect of significant macroeconomic variables; inflation and exchange rate on the flows of Foreign Institutional Investment in India. He has tried to analyze the inter-relation between Foreign Institutional Investment, Exchange Rate and Inflation. Given the large volume of these flows and their impact on domestic financial markets; understanding the major determinants of these flows becomes imperative as the economy has now moved towards full capital account convertibility.

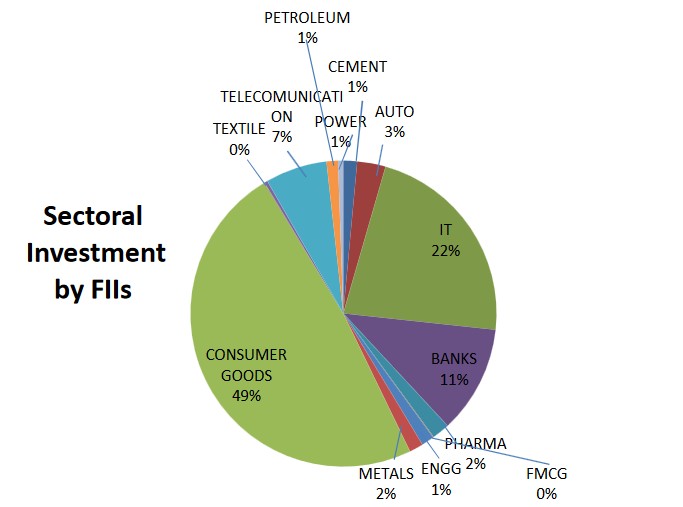
1. **FDI Trends in India**

FDI’S were allowed to invest in capital market securities since September 1992. However these,

|  |  |  |  |
| --- | --- | --- | --- |
| **YEAR** | **YEARLY TREND** | **CHANGE** | **% CHANGE** |
| **2010** | 141627.1 | 56259.49 | **66%** |
| **2009** | 85367.6 | 138419.3 | **261%** |
| **2008** | -53051.7 | -123992 | **-175%** |
| **2007** | 70940.05 | 39658.97 | **127%** |
| **2006** | 31281.08 | -14544.5 | **-32%** |
| **2005** | 45825.6 | 7137.2 | **18%** |
| **2004** | 38688.4 | 8735.2 | **29%** |
| **2003** | 29953.2 | 26325.97 | **726%** |
| **2002** | 3627.23 | -9667.47 | **-73%** |
| **2001** | 13294.7 | 6941.94 | **111.92%** |
| **2000** | 6202.51 | -220.26 | **-3.43%** |
| **1999** | 6422.77 | 7343.73 | **789.91%** |
| **1998** | -930.96 | -7369.49 | **-114.46%** |
| **1997** | 6432.53 | -3130.84 | **-31.71%** |
| **1996** | 9559.37 | 5554.34 | **137.93%** |
| **1995** | 4015.53 | -2877.63 | **-41.79%** |
| **1994** | 6842.66 | 4283.53 | **164.26%** |

have invested from January, 1993 only. The net inflow has risen from Rs. 2608.13 crores in 1993 to Rs. 141627.1 crores in 2010 with relative ups and downs during the period as per the above table .during the period of 18 years there has been increase in in nine years while decline in the rest years It may be concluded that there are significant variations in the yearly inflow of FDIs into the Indian capital market during 1993-2010. During the initial year 1992-93, the FDI flows started in September 1992, which amounted to Rs. 13 crores because at this moment government was framing policy guidelines for FDIs. However, within a year, the FDIs rose to 39338 i.e. 46% of 1992-93 during 1993-94because government had opened door for investment in India. Thereafter, the FDI inflows witnessed a dip of 6.45%.However, the year 1995-1996witnessed a turnaround, gliding up the contribution by FDI to enormous amount of Rs. 6942 crores. Investments made by FDIs during 1996-1997rose a little i.e. 23.52% of that of the preceding year. This period was ripe enough for FDI Investments as that time the Indian economy posted strong fundamentals, stable exchange rate expectations and offered investment incentives and congenial climate for investment of these funds in India. During 1997-98, FDI inflows posted a fall of 30.51%. This slack in investments by FDIs was primarily because of the S-East Asian Crisis and the months of volatility experienced during November 1997 and February 1998. The net investment flows by FDIs have always been positive from the year of their entry. However, only in the year 1998-99, an outflow nearly of Rs. 17699 crores was witnessed for the first time. This was primarily due to the economic sanctions imposed on India by Japan, US and other industrialized economies. These economic sanctions were the result of the testing of series of nuclear bombs by India in May 1998.FDI investment posted a year-on-year decline of 1.8 % in 2000-01, 11.87 % in 2001-02 and 69.29 % in 2002-03. Investments by FDI posted a fall of 80 % in 2002-03 as compared with investments in the period of 1999-00. Investments by FDIs rebounded from depressed levels from the year 2003-04 and witnessed an unprecedented surge. FDIs flows were recycled to India following readjustment of global portfolios of institutional investors, triggered by robust growth in Indian economy and attractive valuations in the Indian equity market as compared with other emerging market economies in Asia. The slowdown in 2004-05 was on account of global uncertainties caused by hardening of crude oil prices and the upturn in the interest rate cycle. The resumption in the net FDI inflows to India from August 2004 continued till end 2004-05. The inflows of FDIs during the year 2004-05 was Rs. 45881 crore. During 2006-07 the foreign institutional investors continued to invest large funds in Indian securities market. Strong FDI flows had been a key characteristic of the period prior to December 2007.

1. **Sectoral investments by FDI’S in India**



It can be seen from the diagram above that the major proportion of FDI investments is into consumer goods and then followed by investments in the IT and the banking sector. It can be observed from the table below that India is one of the preferred investment destinations for FDIs over the years. The total number of FDIs in India has almost grown 99 times since the beginning they were allowed to enter the Indian equity markets.

1. **Impact of FDI on economic indicators in India**

* Balance of payment- A net positive swing in invisibles (due to increase in software exports and remittances sent by Indians working abroad) and increase in investments (both FDI and FDI), has been improving the Balance of Payment (BOP) of the Indian economy and increasing the demand of rupee in the international currency market. In view of this the RBI had been following a policy of buying dollars (by selling rupee) in the international market, thereby avoiding an appreciation of rupee viz-a-viz the dollar.
* Fluctuating Rupee-FDIs convert Dollars to Rupees to invest in Indian Markets-

FDI money comes in India at high Dollar rates. FDI money would go out when Dollar dips to low values. Thereby the new noimnclature for this FDI dollars let be SMART MONEY which finds more money. We’ll now see some major points on Sensex from 2003 with peaks of dollar as that could trigger money push into India ideally:

**Jan –may 2003-** USD/INR roughly 47-48. Sensex moved from 3000 to 6000 and dollar dipped till 43 by May. Market corrected to 4200 after that.

**July –sept 2005-** USD/INR 46 Sensex again moved from 5k to 12k and dollar dipped to 44-43.5. Market corrected to 8800 after that.

**July –sept 2006-** USD /INR 46 -47 Sensex moved from 9k to 21k and dollar dipped to 39. Market corrected to 13k. Maybe this is confusing but from the data it seems FDI dollars starts entering into India when Dollar is quoting at a price of 45-47 or tops out and this money creates the next Bull Run. This withdrawal by the FDI’s lead to a sharp depreciation of the rupee between January 1 and October 16, 2008, the RBI reference rate for the rupee fell by nearly 25 per cent, in relative to dollar, from Rs 39.20 to the dollar to Rs 48.86. This was despite the sale of dollars by the RBI, which was reflected in a decline of $25.8 billion in its foreign currency assets between the end of March 2008 and October 3, 2008. The result has been the observed sharp depreciation of the rupee. While this depreciation may be good for India’s exports that are adversely affected by the slowdown in global markets, it is not so good for those who have accumulated foreign exchange payment commitments. Nor does it assist the Government’s effort to rein in inflation.

* Stock market-

Mathematicians and Statisticians use a measure known as the correlation coefficient, which is used to depict a relationship between two variables mathematically. This coefficient ranges from minus 1 to plus 1. So, if we consider two variables, and the coefficient is -1, it means that when one moves up, the other moves down in the same proportion. When it is 1, it means when one moves up or down, the other also moves in the same manner, and when it is zero, it means there is no correlation. So when one moves up (or down), there’s no way to figure out how the other variable will behave. So basically, one can compute the correlation coefficient between the Sensex and FDI flows.

1. **Conclusion**

FDI inflows show a positive growth trend over the period from 1991 to 2012. Impact of FDI on selected economic indicators is positive. Foreign direct investment raised to 3557 US $ million in the year 1997-98, but declined gradually to 2155 US $ million in 1999-2000. FDI inflows during 2000-2001 have been encouraging. The FDI inflows raised from 6130 US $ million in the year 2001-02 to 46553 US $ Million in 2011-12. The significant increase in FDI inflows to India reflected the impact of liberalization of the economy, and gradual opening up of the capital account.

It is found that FDI inflows in India show positive trend over the period under study. Gross inflows of FDI include 63% share of direct investment in equity and 37% share of portfolio investment. FDI increased due to adoption of more liberal foreign policy and series of measures are undertaken by GOI. It is observed that Mauritius and Singapore had 48% cumulative inflows of FDI. While, studying sectoral perspective, it is found that service sector tops in attracting highest FDI in equity inflows, followed by manufacturing sector. Even in recent global crisis, FDI inflows showed increasing trend. FDI is expected to grow in coming years. It was hypothecated that, the FDI inflows show positive growth trend during the period from 1991-92 to 2011-12’. From the above data analysis and discussion this hypothesis has to be accepted. Correlation analysis results indicated that there is a very high correlation between the FDI inflows and the other related economic indicators as it was hypothecated. Opening FDI in multi-brand retailing has mixed consequences on retail in India.

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