

ROLE OF FOREIGN DIRECT INVESTMENT AND FOREIGN INSTITUTIONAL INVESTMENT IN INDIAN ECONOMY

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ABSTRACT

Foreign Investment plays a very important role in the long-term development of a country not only as a source of capital but also for enhancing competitiveness of the domestic economy through transfer of technology, strengthening infrastructure, raising productivity and generating new employment opportunities. The role of the role of foreign institutional investment and foreign direct investment in the economic development of a country has received considerable attention in India since independence and of late it is a topic of discussion among economists and development planners. The Indian government differentiates cross-border capital inflows into various categories like foreign direct investment (FDI), foreign institutional investment (FII), non-resident Indian (NRI) and person of Indian origin (PIO) investment. Inflow of investment from other countries is encouraged since it complements domestic investments in capital-scarce economies of developing countries, India opened up to investments from abroad gradually over the past two decades, especially since the landmark economic liberalisation of 1991. FDI and FII are equally connected to investment in a foreign country. Foreign direct investment (FDI) refers to the net inflows of investment to acquire a lasting management interest (10 percent or more of voting stock) in an enterprise operating in an economy other than that of the investor where the FII or Foreign Institutional Investor is an investment prepared by an investor in the markets of a foreign country. Therefore an attempt has been made in this paper Know the impact of foreign direct investments and foreign institutional investment on the real economic growth in India over a period 2001-02 to 2012-13.

KEYWORDS: *FDI (Foreign DirectInvestment), FII (Foreign Institutional Investment), Economic Growth and GDP (Gross Domestic Product).*

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INTRODUCTION

India's Foreign Direct Investment (FDI) policy has been gradually liberalised to make the market more investor friendly. The results have been encouraging. These days, the country is consistently ranked among the top three global investment destinations by all international bodies, including the World Bank, according to a United Nations (UN) report. The economic landscape of India underwent a paradigm change when the economy was liberalized in 1991. It also laid the foundation for a strong regulatory network. Indian economy has been one of the stars of global economy in recent years, growing at around 8% consistently. India, today, has a vibrant economy and is recognized as a leader among the emergent countries with a huge potential for growth. India is now initiating the second generation reforms intended for a faster integration of the Indian economy with the world economy. In the present decade India has witnessed unprecedented levels of economic expansion and also seen healthy growth of trade. GDP reflects the potential market size of Indian economy. India witnessed stellar economic performance through the period 2001-10. This was manifested through an average 8.5 - 9 percent GDP growth rates, rising domestic savings and investment levels and the amount of foreign capital flowing into the country.

Nation's progress and prosperity is reflected by the pace of its sustained economic growth and development. Investment provides the base and pre-requisite for economic growth and development. Apart from a nation's foreign exchange reserves, exports, government's revenue, financial position, available supply of domestic savings, magnitude and quality of foreign investment is necessary for the well-being of a country. United Nations Conference on Trade and Development report on world investment prospects India has been ranked at the third place in global foreign direct investments in 2009 and will continue to remain among the top five attractive destinations for international investors 2012-13. Developed economies consider FDI as an engine of market access in developing and less developed countries vis-à-vis for their own technological progress and in maintaining their own economic growth and development. Developing nations look at FDI as a source of filling the savings, foreign exchange reserves, revenue, trade deficit, management and technological gaps. FDI is considered as an instrument of international economic integration as it brings a package of assets including capital, technology, managerial skills and capacity and access to foreign markets. The impact of FDI depends on the

country's domestic policy and foreign policy. As a result FDI has a wide range of impact on the country's economic policy. One of the main reasons for the FII flows has been an increased recognition of the long-term growth potential of Indian economy. India offers favourable demographics and has quickly established its competitive advantage in many spheres including software. Indian entrepreneurs have been quite successful in launching businesses in India. FIIs have recognised the fact and unlike other countries where FDI has gained predominance, India has seen significant growth in FII investment. Though there could be temporary slowdown or reversals based on interest rate cycles, flow of funds, global contagion etc, over the long term, given the nascence of many Indian businesses and the growth potential, one would see continued inflows

REVIEW OF LITRATURE

1. **Bakaert and Harvey** (2000) found a positive relationship between portfolio flows and the growth rate of an economy. They also found that across a range of specifications, the cost of capital always decreases after capital markets are liberalized, with the effect varying between 5 and 75 basis points (p. 596). Further, they found a small but mostly insignificant increase in the volatility of stock returns following the liberalization of capital markets. **Mukherjee, Bose and Coondoo** (2002) studied in their paper —the cause-and-effect relationship between FII flows and returns on the Indian equity market|| . They found that FII flows to and from the Indian market tend to be caused by returns in the domestic equity market and not the other way round.**Iyare Sunday O, Bhaumik Pradip K, Banik Arindam** (2004), in their work—Explaining FDI Inflows to India, China and the Caribbean: An Extended Neighborhood Approach found out that FDI flows are generally believed to be influenced by economic indicators like market size, export intensity, institutions etc. irrespective of the source and destination countries. This paper looks at FDI inflows in an alternative approach based on the concepts of neighborhood and extended neighborhood. The study shows that the neighborhood concepts are widely applicable in different contexts particularly for China and India, and partly in the case of the Caribbean. There are significant common factors in explaining FDI inflows in select regions. While a substantial fraction of FDI inflows may be explained by select economic variables, country – specific factors and the idiosyncratic component account for more of the investment inflows in Europe, China and India.**Salisu A.**

Afees (2004) in his study —The Determinants and Impact of Foreign Direct Investment on economic Growth in Developing Countries: A study of Nigeria|| examines the determinants and impact of Foreign Direct Investment on economic Growth in Developing Countries using Nigeria as a case study. The study observed that inflation, debt burden, and exchange rate significantly influence FDI flows into Nigeria. The study suggests the government to pursue prudent fiscal and monetary policies that will be geared towards attracting more FDI and enhancing overall domestic productivity, ensure improvements in infrastructural facilities and to put a stop to the incessant social unrest in the country. The study concluded that the contribution of FDI to economic growth in Nigeria was very low even though it was perceived to be a significant factor influencing the level of economic growth in Nigeria.

Tomsaz Mickiewicz, Slavo Rasosevic and Urmaz Varblane (2005), in their study- The Value of Diversity: Foreign Direct Investment and Employment in Central Europe during Economic Recovery, examine the role of FDI in job creation and job preservation as well as their role in changing the structure of employment. Their analysis refers to Czech Republic, Hungary, Slovakia and Estonia. They present descriptive stage model of FDI progression into Transition economy. They analyzed the employment aspects of the model. The study concluded that the role of FDI in employment creation/ preservation has been most successful in Hungary than in Estonia. The paper also find out that the increasing differences in sectoral distribution of FDI employment across countries are closely relates to FDI inflows per capita. The bigger diversity of types of FDI is more favorable for the host economy. There is higher likelihood that it will lead to more diverse types of spillovers and skill transfers. If policy is unable to maximize the scale of FDI inflows then policy makers should focus much more on attracting diverse types of FDI.

Rhys Jenkins (2006) in his study —Globalization, FDI and Employment in Vietnam|| , examines the impact of FDI on employment in Vietnam, a country that received considerable inflow of foreign capital in the 1990s as part of its increased integration with the global economy. The study shows that the indirect employment effects have been minimal and possibly even negative because of the limited linkages which foreign investors create and the possibility of —crowding out of domestic investment|| . Thus, the study finds out that despite the significant share of foreign firms in industrial output and exports, the direct employment generated has been limited because of the high labor productivity and low ratio of value added to output of much of this

investment. Roy (2007) explored in his paper —the basic motives behind foreign portfolio capital flows into India|| . He found that they are primarily driven by capital gains, and in the Indian case, by the change in stock prices. The study further revealed that stock prices are causing net foreign portfolio inflows and not vice-versa. Further, he found bi-directional causality between the exchange rate and net foreign portfolio inflows.

OBJECTIVES

- To study the behavioral pattern of investment by FDI and FII.
- To study the role of FDI and FII in Indian economy.
- To investigate the direction of relationship between FII investment and FDI investment with the economic growth in India.

METHODOLOGY

SOURCES OF DATA COLLECTION

The study is based on published sources of data collected from various sources. The data has been extracted from the following sources:

- Handbook of Statistics on the Indian economy, RBI, various issues
- Economic Survey, Government of India, various issues
- Department of Industrial Policy and Promotion (DIPP)
- Secretariat of Industrial Assistance (SIA)
- Central Statistical Organization (CSO)

PERIOD OF STUDY

To evaluate the magnitude of FDI and FII inflows and their impact on growth of the country the study is undertaken for a period of 13 years from 2001-02 to 2012-13

TOOLS USED FOR ANALYSIS

The Karl Pearson's bivariate correlation analysis has been used with the help of SPSS to evaluate the degree of correlation and consequent impact of Foreign Direct Investment (FDI) and Foreign Institutional Investment (FII) with Gross Domestic Product (FC)

DISCUSSION**EFFECT OF FDI ON INDIAN ECONOMY**

1. Improve balance of payment position by crediting the inflow of investment to capital account. Also current account improves as FDI aids import substitution/export promotion. Export gets a boost through the expertise of foreign investors possessing export market intelligence and their mechanism. Updates technology of producing world standard goods at low cost are available to the host country. Export credits from the cheapest source in the international market can be availed of quite easily.
2. Foreign firms foster forward and backward economic linkages. Demand for various inputs gives rise to the development of the supplying industries which through employment of labour force raise their income and increase the demand for domestic industrial production. The living standard of the domestic consumers improves as quality products at competitive prices are available. Also a pool of trained personnel is created in this context.
3. Foreign investor by investing in economic/social infrastructure, financial market and marketing system helps the host country to develop a support base essential for quick industrialisation. The presence of foreign investors creates a multiplier effect leading to the emergence of a sound support system.
4. Foreign investors are a boon to government to revenue with regard to the generation of additional income tax. Also they pay tariff on their imports. Governmental expenditure requirements are greatly reduces through supplementing government's investment activities in a big way there by lessening the burden on national budget.
5. FDI aids to maintain a proper balance amongst the factors of production by the supply of scarce resources thereby accelerating economic growth. Capital brought in by FDI supplements domestic capital as the savings rate at home is very low to augment heavy investment. Through the inflow of scarce foreign exchange, domestic savings get a boost to support the investment process. Foreign investors are bold enough to take risks not prevalent among local investors resulting in investment projects being implemented in a large way. FDI's bring in skilled labour force to perform jobs which local workers are unable to carry out. There is also a fear of imposition of alien culture being imposed on

the local labour force. Foreign investors make available key raw materials along with updated technology to the host country. Such a practice helps the host country to obtain access to continued updation of R&D work of the investing company.

EFFECTS OF FII ON INDIAN ECONOMY

Let us study the positive and the negative side of this rise of investments by FIIs one by one.

POSITIVE IMPACT

It has been emphasized upon the fact that the stock market reforms like improved market transparency, automation, dematerialization and regulations on reporting and disclosure standards were initiated because of the presence of the FIIs. But FII flows can be considered both as the cause and the effect of the stock market reforms. The market reforms were initiated because of the presence of them and this in turn has led to increased flows.

1. ENHANCED FLOWS OF EQUITY CAPITAL

FIIs are well known for a greater appetite for equity than debt in their asset structure. For example, pension funds in the United Kingdom and United States had 68 per cent and 64 per cent, respectively, of their portfolios in equity in 1998. Not only it can help in supplementing the domestic savings for the purpose of development projects like building economic and social infrastructure but can also help in growth of rate of investment, it boosts the production, employment and income of the host country.

2. MANAGING UNCERTAINTY AND CONTROLLING RISKS

FIIs promote financial innovation and development of hedging instruments. These because of their interest in hedging risks, are known to have contributed to the development of zero-coupon bonds and index futures. FIIs not only enhance competition in financial markets, but also improve the alignment of asset prices to fundamentals. FIIs in particular are known to have good information and low transaction costs. By aligning asset prices closer to fundamentals, they stabilize markets. In addition, a variety of FIIs with a variety of risk-return preferences also help in dampening volatility.

3. IMPROVING CAPITAL MARKETS

FII's as professional bodies of asset managers and financial analysts enhance competition and efficiency of financial markets. By increasing the availability of riskier long term capital for projects, and increasing firms' incentives to supply more information about them, the FII's can help in the process of economic development.

4. IMPROVED CORPORATE GOVERNANCE

Good corporate governance is essential to overcome the principal-agent problem between shareholders and management. Information asymmetries and incomplete contracts between shareholders and management are at the root of the agency costs. Bad corporate governance makes equity finance a costly option. With boards often captured by managers or passive, ensuring the rights of shareholders is a problem that needs to be addressed efficiently in any economy. Incentives for shareholders to monitor firms and enforce their legal rights are limited and individuals with small share-holdings often do not address the issue since others can free-ride on their endeavor. FII's constitute professional bodies of asset managers and financial analysts, who, by contributing to better understanding of firms' operations, improve corporate governance.

Among the four models of corporate control - takeover or market control via equity, leveraged control or market control via debt, direct control via equity, and direct control via debt or relationship banking-the third model, which is known as corporate governance movement, has institutional investors at its core. In this third model, board representation is supplemented by direct contacts by institutional investors.

NEGATIVE IMPACT

If we see the market trends of past few recent years it is quite evident that Indian equity markets have become slaves of FII's inflow and are dancing to their tune. And this dependence has to a great extent caused a lot of trouble for the Indian economy. Some of the factors are:

1. POTENTIAL CAPITAL OUTFLOWS

Hot money refers to funds that are controlled by investors who actively seek short-term returns. These investors scan the market for short-term, high interest rate investment opportunities. Hot

money can have economic and financial repercussions on countries and banks. When money is injected into a country, the exchange rate for the country gaining the money strengthens, while the exchange rate for the country losing the money weakens. If money is withdrawn on short notice, the banking institution will experience a shortage of funds.

2. INFLATION

Huge amounts of FII fund inflow into the country creates a lot of demand for rupee, and the RBI pumps the amount of Rupee in the market as a result of demand created. This situation leads to excess liquidity thereby leading to inflation where too much money chases too few goods.

3. PROBLEM TO SMALL INVESTORS

The FIIs profit from investing in emerging financial stock markets. If the cap on FII is high then they can bring in huge amounts of funds in the country's stock markets and thus have great influence on the way the stock markets behaves, going up or down. The FII buying pushes the stocks up and their selling shows the stock market the downward path. This creates problems for the small retail investor, whose fortunes get driven by the actions of the large FIIs.

4. ADVERSE IMPACT ON EXPORTS

FII flows leading to appreciation of the currency may lead to the exports industry becoming uncompetitive due to the appreciation of the rupee.

TABLE 01: RELATIONSHIP BETWEEN FDI, FII AND GDP (FC)

Financial Year	FDI	FII	GDP (At Factor Cost)
2001-02	19361	8763	2097726
2002-03	14932	2689	2261415
2003-04	12117	45765	2538171
2004-05	17138	45881	2971464
2005-06	24613	41467	3254216
2006-07	70630	30840	3566011
2007-08	98664	66179	3898958
2008-09	85700	-45811	4162509
2009-10	123120	142658	4507637

2010-11	88520	146438	4877842
2011-12	173946	93726	5243583
2012-13	121907	168367	5503476

Source: various issues of RBI Bulletin.

This table shows the relationship between foreign direct investment, foreign institutional investments or and the real economic growth in India over a period 2000-01 to 2012-13.

TABLE 02: CORRELATION BETWEEN FDI & GDP

		FDI	GDP
FDI	Pearson Correlation	1	.909**
	Sig. (1-tailed)		.000
	N	12	12
GDP	Pearson Correlation	.909**	1
	Sig. (1-tailed)	.000	
	N	12	12

** . Correlation is significant at the 0.01 level (1-tailed).

Source: Result of Karl Pearson’s bivariate correlation analysis calculated with the help of SPSS 16.0.

The value of Karl Pearson co relation(r) is found to be +0.909. It means that there is high degree positive correlation between the FDI and GDP.

The value of Karl Pearson co relation(r) is found to be +0.697.It means that there is medium degree positive correlation between the FII and GDP.

CONCLUSION

On the basis of above discussion and data analysis, it is clear that the FII and FDI are influencing the economic development to a greater extent. FDI is preferred over FII investments since it is considered to be the most beneficial form of foreign investment for the economy as a whole. Direct investment targets a specific enterprise, with the aim of increasing its capacity/productivity or changing its management control. Direct investment to create or augment capacity ensures that the capital inflow translates into additional production. In the case of FII investment that flows into the secondary market, the effect is to increase capital availability in general, rather than availability of capital to a particular enterprise. Translating an FII inflow into additional production depends on production decisions by someone other than the foreign investor — some local investor has to draw upon the additional capital made available via FII inflows to augment production. In the case of FDI that flows in for the purpose of acquiring an existing asset, no addition to production capacity takes place as a direct result of the FDI inflow. Just like in the case of FII inflows, in this case too, addition to production capacity does not result from the action of the foreign investor – the domestic seller has to invest the proceeds of the sale in a manner that augments capacity or productivity for the foreign capital inflow to boost domestic production. There is a widespread notion that FII inflows are hot money that it comes and goes, creating volatility in the stock market and exchange rates. While this might be true of individual funds, cumulatively, FII inflows have only provided net inflows of capital. The Pearson correlation values indicate positive correlation between both the foreign direct investment and foreign institutional investments with GDP (pearson's correlation values are 0.909, 0.697 respectively).

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