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Role of Foreign direct investment (FDI) and foreign institutional investors (FII) in India

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Abstract

A) FOREIGN DIRECT INVESTMENT (FDI)

Net foreign direct investment (FDI) flows into India reached 123,378 crore in the year 2010-11, it means increase of 147% of the 18486 crore recorded during 2000-01, with the largest share of FDI flows from Mauritius, followed by the United States and the United Kingdom. This paper examines FDI in India, in the context of the Indian economic and regulatory environment. This paper present FDI trends in India, by country and by sectors during the post liberalization period that is 2000 to 2010 year, using official government data from Indian official government internet site like that of RBI, SEBI. To illustrate the driving forces behind these trends, the study also discusses the investment climate in India, Indian government incentives to foreign investors, the Indian regulatory environment as it affects investment, and the effect of India's global, regional, and bilateral trade agreements on investment from top 10 FDI investing countries. Finally, the study examines global FDI in India's in top 10 sectors of industry.

B) FOREIGN INSTITUTIONAL INVESTORS (FII)

Institutional Investor is any investor or investment fund that is from or registered in a country outside of the one in which it is currently investing. Institutional investors include hedge funds, insurance companies, pension funds and mutual funds. The growing Indian market had attracted the foreign investors, which are called Foreign Institutional Investors (FII) to Indian equity market, and *this paper present try to explain the impact and extent of foreign institutional investors in Indian stock market and examining whether market movement can be explained by these investors. It is often hear that whenever there is a rise in market, it is explained that it is due to foreign investors' money and a decline in market is termed as withdrawal of money from FIIs. This paper tries to examine the influence of FII on movement of Indian stock exchange during the post liberalization period that is 2000 to 2010.*

Introduction

Foreign investment refers to investments made by the residents of a country in the financial assets and production processes of another country. The effect of foreign investment, however, varies from country to country. It can affect the factor productivity of the recipient country and can also affect the balance of payments. Foreign investment provides a channel through which countries can gain access to foreign capital. It can come in two forms: foreign direct investment (FDI) and foreign institutional investment (FII). Foreign direct investment involves in direct production activities and is also of a medium- to long-term nature. But foreign institutional investment is a short-term investment, mostly in the financial markets. FII, given its short-term nature, can have bidirectional causation with the returns of other domestic financial markets such as money markets, stock markets, and foreign exchange markets. Hence, understanding the determinants of FII is very important for any emerging economy as FII exerts a larger impact on the domestic financial markets in the short run and a real impact in the long run. India, being a capital scarce country, has taken many measures to attract foreign investment since the beginning of reforms in 1991.

Objective of the paper:

Objective 1 pertaining to FDI: examines the trends and patterns in the foreign direct investment (FDI) across different sectors and from different countries in India during 2000-2010 periods.

Objective 2 pertaining to FII: influence of FII on movement of Indian stock exchange during the post liberalization period that is 2000 to 2010.

Data collection:

This study is based on secondary data. The required data have been collected from various sources i.e. World Investment Reports, Asian Development Bank's Reports, various Bulletins of Reserve Bank of India, publications from Ministry of Commerce, Govt. of India, Asian Development Outlook, Country Reports on Economic Policy and Trade Practice- Bureau of Economic and Business Affairs, U.S. Department of State and from websites of World Bank, IMF, WTO, RBI, UNCTAD, EXIM Bank etc.. It is a time series data and the relevant data have been collected for the period 2000 to 2010.

1. about foreign direct investment.

Foreign direct investment (FDI) refers to cross-border investment made by a resident in one economy (the direct investor) with the objective of establishing a lasting interest in an enterprise (the direct investment enterprise) that is resident in a country other than that of the direct investor (OECD 2008). The motivation of the direct investor is strategic "lasting interest" in the management of the direct investment enterprise with at least 10 per cent voting power in decision making. The host country aspires to receive FDI inflows because of the potential benefits, the most established benefit being that FDI supplements the domestic savings of a nation. Other payoffs include access to superior international technologies, exposure to better management and accounting practices, and improved corporate governance. FDI is likely to expand and/or diversify the production capacity of the recipient country which, in turn, is expected to enhance trade.1 on the other side, foreign investors are motivated by profits and access to natural resources. Therefore, large and growing domestic markets are likely to receive more FDI. Countries with abundant natural resources such as mines, oil reserves and manpower appear prominently on the investment maps of foreign investors.

While the objectives of FDI can be different from the home and the host country's perspectives, one of the major aims of attracting FDI is overall development of the recipient country keeping some specific strategy in view. This can be done by achieving higher FDI inflows (China, Malaysia and Singapore), maximizing technology spill-over into the domestic economy (South Korea and Taiwan), or imposing local content requirements (East and South-East Asia).

Foreign direct investment: Indian scenario.

Foreign Direct Investment (FDI) is permitted as under the following forms of investments.

· Through financial collaborations.

· Through joint ventures and technical collaborations.

· Through capital markets via Euro issues.

· Through private placements or preferential allotments.

There have been significant changes in the growth models of developing economies during the past two decades. Many of these economies, including India, have moved away from inward-oriented import substitution policies to outward oriented and market-determined export-oriented strategies. The skepticism about the role of FDI in reinforcing domestic growth has given way to greater openness to FDI, with a view to supporting investment and productivity of the host countries. While developing countries have started accepting FDI inflows with some caution, which is obvious the developed countries have moved their investments to foreign locations, subject to safety and profitability of their business operations in foreign lands.

Indian joint stock Companies which were subsidiaries of foreign companies, in which 40 per cent or more of the equity capital was held outside India in any one country and companies in which 25 per cent or more of the equity capital was held by a foreign company or its nominee were treated as Foreign-Controlled Rupee Companies (FCRCs).

Foreign Direct Inflows in India: (Table 1.1)

(Amount in crores)

Year	FDI inflows in India
2000-01	10368
2001-02	18486
2002-03	13711
2003-04	11789
2004-05	14653
2005-06	24613

2006-07	70630
2007-08	98664
2008-09	123025
2009-10	595101

Source: RBI bulletin.

From the above table flow of FDI is playing a significant and contributory role in the economic growth of the country. In 2009-10, India's FDI touched Rs. 595101 crores up against Rs. 123025 crores in 2008-09 and the country's foreign exchange reserves touched a new high of Rs.1283865 crores in 2009-10. As a result of India's economic reforms, the country's annual growth rate has averaged 8.50% during 2000-2010.

Analysis of share of top ten investing countries FDI equity in flows in India. (Table 1.2)

Rank	Country	Cumulative inflows (from 2000 to 2010) Amount Rupees in crore.	%age with total inflows (in terms of rupees)
1.	Mauritius	79162	34.11
2.	U S A	24536	10.57
3.	U.K	16660	7.17
4.	Netherlands	11402	4.91

5.	Japan	9313	4.01
6.	Germany	7060	3.04
7.	Singapore	7050	3.03
8.	France	3803	1.63
9.	South Korea	3234	1.39
10.	Switzerland	2879	1.24

Source: Issues of RBI bulletin

Foreign investors have begun to take a more active role in the Indian economy in recent years. By country, the largest direct investor in India is Mauritius; largely because of the India Mauritius double-taxation treaty. Firms based in Mauritius invested 79162 crores in India between 2000 and March 2010, equal to 34.11 percent of total FDI inflows. The second largest investor in India is the United States, with total capital flows of 24536 crore during the 2000–2010 periods, followed by the United Kingdom, the Netherlands, and Japan.

Analysis of sectors attracting highest FDI equity inflows in India (Table1.3)

Rank	Sector (Share as % of total investment) Jan 2000-March 2009	2010
1.	Service sector (21.2)	Service sector(24.3)
2.	Computer software & Hardware (9.9)	Telecommunications (8.3)
3.	Telecommunications (8.3)	Housing & Real Estate (including Cineplex, Multiplex, Integrated Townships & Commercial Complexes) (8.1)
4.	Housing & Real Estate (including Cineplex, Multiplex, Integrated Townships & Commercial Complexes, etc.) (6.1)	Construction Activities (7.4)
5.	Construction Activities (5.7)	Computer Software & Hardware (5.6)
6.	Automobile industry (3.9)	Metallurgical industries (4.5)
7.	Power (3.6)	Ports (4.0)
8.	Metallurgical industries (3.0)	Petroleum & Natural Gas (4.0)
9.	Petroleum & Natural Gas (2.6)	Power(3.9)
10.	Chemicals (other than fertilizers) (2.4)	Automobile industry (3.4)

The sectors receiving the largest shares of total FDI inflows between Jan 2000 and March 2009 were the services sector, accounting for 21.2%. This was followed by the computer software and hardware, telecommunications, housing& real estate, power, and chemicals sectors. The top sectors attracting FDI into India via M&A activity were manufacturing; information; and professional, scientific, and technical services. These sectors correspond closely with the sectors identified by the Indian government as attracting the largest shares of FDI inflows overall.

EMERGING ECONOMIES OF THE WORLD.

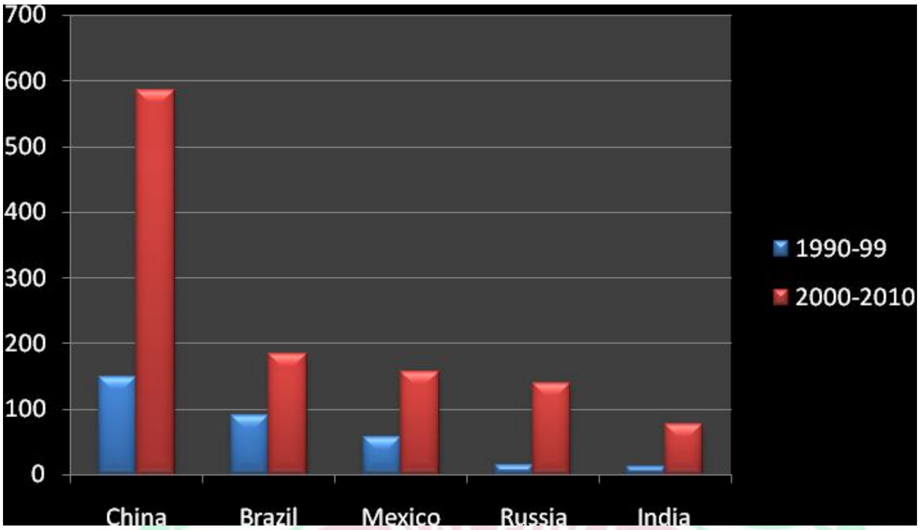
The following table reveals that during the period under review FDI inflow in India has increased from 11% to 69%. But when it is compared with China, India's FDI inflows stand no where. And when it is compared with rest of the major emerging destinations of global FDI India is found at the bottom of the ladder. The reason could be bureaucratic hurdles, infrastructural problems, business environment, or government stability. India has to consider the five point strategy as put forward by the World Bank for India, if India wants to be an attractive location of global FDI in the coming years.

Most attractive Location of Global FDI (Table 1.4)

Amount in US $ Billion

Year/ Country	China	Brazil	Mexico	Russia	India
1990-99	148.5	89.4	56.4	15	11.4
2000-2010	586	184	156.2	139.4	76.2

Source: compiled from the various issues of WIR, UNCTAD, World Bank



Foreign Institutional Investment in India.

With the emerging market crises of the late 1990s, the role of Foreign Portfolio Investment (FPI) and the major players therein i.e. the foreign institutional investors (FIIs) has come under intense scrutiny by academics as well as policymakers. A general perception about the FIIs is that they are speculators and their investment is motivated by short- term gains. The FIIs in pursuit of short- term gains adopt short- term trading strategies such as positive feedback trading and herding (i.e. buy or sell stocks together as a group). Such behavioral biases of FIIs, it is believed, may lead to price overreaction and contribute to the creation or exacerbation of a financial crisis.

In case of India, investment by FIIs has seen a steady growth since the opening of the equity markets in September 1992. The share of FIIs in total FPI has increased from 47% in 1993-94 to around 74% in 2001-2002. FIIs have also acquired a significant presence in the Indian stock market. The share of their trading in total turnover attained a high of almost 30% in October 2001. In total market capitalization[1] FIIs account for about 13% and they make about 50-60% of average daily deliveries on the stock market.

Notwithstanding the FIIs being important players in the Indian stock market and that there are strongly held views on their trading behavior biases, little empirical analysis on the subject in the Indian context has been undertaken. In this paper an effort has been made to develop an understanding of the dynamics of the FII inflows and equity returns in the Indian equity market.

Market design in India for foreign institutional investors.

Foreign Institutional Investors means an institution established or incorporated outside India which proposes to make investment in India in securities. A Working Group for Streamlining of the Procedures relating to FIIs, constituted in April, 2003, inter alia, recommended streamlining of SEBI registration procedure, and suggested that dual approval process of SEBI and RBI be changed to a single approval process of SEBI. This recommendation was implemented in December 2003. Currently, entities eligible to invest under the FII route are as follows:

i) As FII: Overseas pension funds, mutual funds, investment trust, asset management company, nominee company, bank, institutional portfolio manager, university funds, endowments, foundations, charitable trusts, charitable societies, a trustee or power of attorney holder incorporated or established outside India proposing to make proprietary investments or with no single investor holding more than 10 per cent of the shares or units of the fund).

(ii) As Sub-accounts: The sub account is generally the underlying fund on whose behalf the FII invests. The following entities are eligible to be registered as sub-accounts, viz. partnership firms, private company, public company, pension fund, investment trust, and individuals.

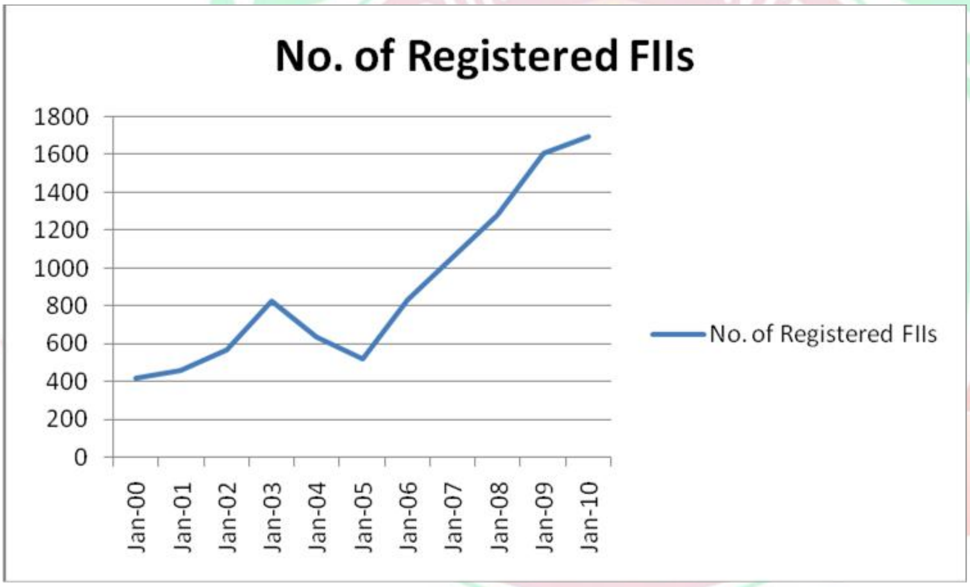
REGISTERED FII'S IN INDIA. (Table 2.1)

The Indian capital market opened its door to foreign investors in 1991. The new industrial policy of the government has initiated many measures to attract foreign capital. The following table highlights the registered FIIs in India during the period from 2000-2010.

Year	No. of Registered FIIs
January 2000	416
January 2001	459
January 2002	566
January 2003	823
January 2004	637
January 2005	517

January 2006	833
January 2007	1059
January 2008	1279
January 2009	1609
January 2010	1697

Source: SEBI



From the above it is clear that there is constant growth in registered FIIs in India. In the year 2006 (January 2006), the number of registered FIIs were 833 only. The same has been increased to 1697 by the year 2010 (January 2010). The number has been increased more then 100%. In spite of the global crises the number of FIIs has shown a significant increase. Irrespective of situation in Indian stock markets these FIIs has earmarked their presence. But the investment made by FIIs has experiences drastic decline in the recent past. This is mainly because of the global economic meltdown. Though the number of registered FIIs increased the net investment were not increased proportionately.

Composition of Foreign Portfolio investment in India (Table 2.2)

Year	GDR/AD Rs	FIIs	Off-Shore funds and others	Total Foreign portfolio investment	% contribution of FIIs to Total Foreign portfolio flows
2001-02	477	1505	39	2021	74.47
2002-03	600	377	2	979	38.51
2003-04	459	10918	-	11377	95.97
2004-05	613	8686	16	9315	93.25
2005-06	2552	9926	14	12492	79.46
2006-07	3776	3225	2	7003	46.05
2007-08	8769	20328	298	29395	69.15
2008-09	9152	21369	314	30651	69.72
2009-10	9865	23469	357	32458	72.32

Source: SEBI

The share of FII investment in total portfolio investment for 2009-10 is provisionally estimated to be 72.32%. The large FII flows (net) in 2005-06 at 79.46% as against foreign portfolio investment. Looking at trend in FII investments during 2009-10 (Table below), it can be seen that net FII investment has been positive during the year. But during 2008-09, FIIs have been net sellers to the tune of US $ 4,189 million. This can be attributed to the generally weak sentiments of investors following the global credit crisis which has engulfed the developed countries and is seen to be affecting the developing countries as well.

Trend in FII Investment. (Table 2.3)

Period	Purchase (Rs.mn)	Sales (Rs.mn)	Net Investment (Rs.mn)	Net Investment (US $ mn)	Cumulative Net Investment (US $ mn)
2001-02	499199	411650	87552	1846	15242
2002-03	470601	443710	26889	562	15804
2003-04	1448575	990940	457645	9949	25754
2004-05	2169530	1710730	458800	10173	35927
2005-06	3449780	3055120	394660	9334	477063
2006-07	5205090	4896680	308410	6709	51967
2007-08	94860196	8818422	661774	16040	68006
2008-09	1844490	2013450	168960	4189	63819
2009-10	1866735	3235648	675437	16474	69176

Source: SEBI

Foreign Institutional Investments – equity and Debts

FIIs were allowed to invest in the Indian Capital Market securities from September 1992 however investment by them were first made in January 1993. Till December 1998, investments were related to equity only as the Indian gilts market was opened up for FII investment in April 1998. Investments in debt were made from January 1999. Foreign Institutional Investors (FIIs) continued to invest large funds in the Indian securities market.

Year	FIIs	
	Net Investment in Equity	Net investment in Debt
2001-02	80670	6850
2002-03	25280	600
2003-04	399590	58050
2004-05	441230	17590
2005-06	488010	73340
2006-07	252370	56070
2007-08	534038	127753
2008-09	140325	28633
2009-10		

Source: SEBI

From the above two consecutive years in 2004-05 and 2005-06, net investment in equity showed year-on-year increase of 10%. Highest net investment in equity by FIIs was seen in 2007-08 of Rs. 534,038 million (US $ 13,361 million) an increase of 112% over the 2006-07 net investment figure of Rs 252,370 million (US $ 5,790 million) During the first quarter of the fiscal 2008-09, FIIs have been net sellers in the equity market. They have sold equity worth Rs. 140,325 million (US $ 3,267 million). Highest net investment in debt by FIIs was seen in 2007-08 of Rs.127 753 million (US $ 3,196 million). During April 08- June 08, FIIs have been net sellers in the debt markets as well. They have sold Rs. 28,633 million (US $ 667 million) of debt over this period.

Major Findings:

1. It is seen from the analysis that large amount of FDI flows are confined to the Indian economy. But there is a marked increase in the FDI inflows for last three years from 2007-08 onwards.
2. Although India’s share in global FDI has increased considerably, but the pace of FDI inflows has been slower than China, Singapore, Brazil, and Russia.

3. While comparing the share of FDI inflows of China and India during this decade (i.e. 2000-2007) it is found that India's share is barely 2.8 percent while china's share is 21.7 percent.
4. By country, the largest investors in India are Mauritius, the United States, and the United Kingdom. Investors based in many countries have taken advantage of the India-Mauritius bilateral tax treaty to set up holding companies in Mauritius which subsequently invest in India, thus reducing their tax obligations.
5. By industry, the largest destinations for FDI are services sectors, telecommunications, and transportation.
6. The share of FII investment in total portfolio investment for 2009-10 is provisionally estimated low capered to that of the year 2005-06.

CONCLUSION:

Thus, it is found that FDI,FII as strategic components of investment is needed by India for its sustained economic growth and development. FDI is necessary for creation of jobs, expansion of existing manufacturing industries and development of the new one. Indeed, it is also needed in the healthcare, education, R&D, infrastructure, retailing and in long term financial projects. Finally the study observes that FDI is a significant factor influencing the level of economic growth in India. It provides a sound base for economic growth and development by enhancing the financial position of the country. It also contributes to the GDP and foreign exchange reserves of the country.