FDI and Indian Stock Market: An Outlook Ahead

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ABSTRACT

This paper provides a comprehensive review of the issues relating to FDI and Indian stock markets in the globalized era. It then tries to analyze the major policy issues arising out of the various concerns. Finally, it puts forward some policy recommendations for attracting FDI in India.

1. INTRODUCTION

Foreign Direct Investment (FDI) is the acquisition of foreign assets for the purpose of controlling them. FDI occurs when a firm invests directly in facilitating to produce and / or market a product in a foreign country. The US Government Statisticians define FDI as *"Ownership or control of 10 percent or more of an enterprise voting securities or the equivalent interests in an unincorporated U.S. business*" (Quijana, 1990). FDI is net inflow of investment to acquire a lasting management interest (10 percent or more of stock) in an enterprise operating in an economy other than that of the investor. It is the sum of equity capital, investment of earnings, other long term capital and long-term capital, as shown in the balance of payments. Gross capital formation is the sum of gross fixed capital formation, changes in inventories, and acquisitions less disposals of valuables (World Development Indicators, 2003). FDI may take many forms such as; purchase of existing assets in an foreign country, new investment in property, plant and equipment, and participation in Joint Venture with a local partner.

Global economic events of the past decade or so, particularly those driven by technological advances, regional integration and the realignment of economic systems and policies, have altered fundamentally the perception of the governments of the host countries of how FDI can contribute towards their economic and social goals (Dunning, 1994). At the same time, financial markets and especially stock markets have grown considerably in developed and developing countries over the last two decades. Better fundamentals (higher economic growth, more macro stability), structural reforms (notably privatization of state owned enterprises), and specific policy changes (notably domestic financial reform and capital account liberalization) have added in their growth. Globalization has also advanced in the last twp decades with tighter links among financial markets and greater commercial presence of foreign financial firms around the world.

This globalization of financial markets has gone together with an increase in cross border capital flows. In 1970s and 1980s, private capital flows have taken the form of syndicate bank loans. After the debt crisis of the early 1980s, capital flows come to an abrupt end in 1982. By the late 1980s, there was a revival of international lending, with capital flows to Latin America making a tremendous comeback. Capital flows to Asia also surged, increasing ten-fold from their averages in the late 1980s.

JOURNAL OF COMMERCE & TRADE

2. FDI IN INDIA

Indian economy has been entering into progressive liberalization since the beginning of 90s. Its reform has been realized in the form of industrial de-licensing, liberal FDI regime, freedom to invest and expand simplification of investment procedures, tax rationalization, current account convertibility and WTO compatibility etc. It is popularly known as the first generation reforms. Recently as the second generation reform, there have been progressive reforms in the way of public sector disinvestments, cutting fiscal deficit, amendments to crucial economic legislations, further tax reforms, financial sector reforms, labour reforms and corporate governance etc. Govt. of India replaced FERA, 1973 that regulated all foreign exchange transactions with Foreign Exchange Management Act (FEMA), 1999. Many of the FDI approval process have been simplified to smoothen the approval process with the enactment of this act.

A major feature of economic reforms in India since 1991 has been a progressive liberalization of external capital flows especially non-debt creating one like FDI and Foreign Institutional Investment (Rakshit, M (2006).With the progressive liberalization of FDI policy, the perception of the foreign investors in India has also been changing. It was argued that compared with FIIs and NRI deposits, the FDI inflow tend to have a large impact on domestic capital formation, effect a smaller fall in domestic saving and create fewer problems for monetary and fiscal authorities. FDIs are also usually preferred over other forms of external finance because they are non-debt creating and non-volatile. India appears on course to attract a record $ 12 billion of FDI this fiscal, going by inflows in the first four months which have almost doubled from a year ago at $ 2.9 billion.

FDI inflows in April –July 2006-07 increased by 92% to $2.9 billion from $1.5 billion during the previous corresponding period. India is set to receive $ 12 billion in the current year against $8.3 billion in 2005-2006(Kamal Nath, Commerce Minister, India)"

3. BENEFITS OF FDI IN THE GLOBALIZED ECONOMY OF INDIA

The different categories of FDI are commonly grouped into two, such as (a) "Greenfield' investments i.e. those to build new capacity; and (b) 'mergers and acquisitions (M&A)' i.e. the acquisition of assets of existing local firms. The benefits of these two groups of FDI, as of all other capital flows, to developing countries are expected to arise through two major mechanisms (i) by increasing total domestic investment, and (ii) by increasing productivity. Ultimately, both effects are expected to result in higher growth rates. Further, the benefits of FDI can elaborately discuss on the following points.

FDI can be used in bridging the financial gap between the quantum of funds needed to sustain a el of growth and the domestic availability of funds .It gives opportunities to Indian industry for technological up gradation, gaining access to global managerial skills and practices, optimizing utilization of human and natural resources, and competing internationally with higher efficiency.

FDI and off shoring activities like IT, contact centres, distribution back office, knowledge management, research and development etc. are also creating jobs, exports and new industries. Indian cities like Bangalore, New Delhi and Mumbai have arisen as popular offshore hubs in Asia. The largest transnational corporation in the world, General Electric has 2,400 employees in India, conducting R & D in a variety of areas ranging from aircraft engines and medical devices to consumer durables. FDI can in fact enhance domestic competition if a global player sets up a Greenfield project, thus expanding the number of domestic producer of the good.

4. FDI INFLOWS IN INDIA : EMERGING TRENDS

FDI can enter India through two possible channels: (i) The automatic route under which companies receiving FDI need to inform the RBI within 30 days of receipt of funds and issuance of shares to the foreign investor, (ii) For sectors that are not covered under the automatic route, prior approval is needed from the Foreign Investment Promotion Board (FIPB). Further, FDI is permitted in India in the forms through financial collaborations, joint ventures and technical collaborations, capital market via euro issues and through private placements. But some sectors are prohibited for FDI to enter like retail trading (except single brand product retailing), atomic energy, lottery business, and gambling & betting. However, it is worth mentioning here that the policy on Foreign Direct Investment has been reviewed on a continuing basis and several measures announced from time to time for rationalization/liberalization of the policy and simplification of procedures.

Acceleration of liberalization process and globalization of FDI driven significant change in the FDI policy of the country. Taking regular review and its appropriate changes in the policy, now, FDI is permitted in most of the sectors of our economy. The FDI inflows since 1991-92 till 2005-06 is gradually increasing from US$ 129 million in 1991-92 to US$ 7,751 million in 2005-06 with some volatility in between the years. Till 1997-98 there has been gradual increase since 1991. Then the fluctuation started from the next financial years i.e. 1998-1999 onwards (Table No. 1)

Table No. 1

FDI inflows in India (Million Dollars)

Year	FDI Inflows	% of increase/ decreased
1992-92	129	–
1992-93	315	144.18
1993-94	586	86.03
1994-95	1,314	124.23
1995-96	2,144	63.16
1996-97	2,821	31.57
1997-98	3,557	26.09
1998-99	2,462	-30.78
1999-00	2,155	-12.46
2000-01	4,029	86.96
2001-02	6,130	52.14
2002-03	5,035	-17.86
2003-04	4,322	-7.18
2004-05 (P)	5,652	30.77
2005-06 (P)	7,751	37.13

Source: RBI Bulletin (June 2004 & July 2006)
Note: FDI data have been revised since 2000 – 01 with expanded coverage to approach international best practices. Therefore, these data are not comparable with that of previous years.

5. FDI AND INDIAN STOCK MARKET

The Indian stock market is one of the earliest in Asia being in operation since 1875, but it remained largely outside the global integration process until the late 1980s. A number of developing countries in concert with the International Finance Corporation and the World Bank took steps in the 1980s to establish and revitalize it as an effective way of mobilizing and allocation of Securities and Exchange Board of India in 1988. Since then, India's stock market driven by expanding inflows of foreign capital into the country on the back of expectations for continued high economic growth and the booming economies of BRICs (Brazil, Russia, India and China). The result was that the Mumbai Stock Exchange's

SENSEX index, India's key stock index, soared 43% in 2005. In this year, despite undergoing temporary corrections, the SENSEX stock index (BSE) and NIFTY (NSE) rose 43% and 36% respectively. Contributing significantly to India's rising stock prices has been an influx of foreign investment. A look at the trend of its balance of payments statistics show that, while the current account figures since late 2004 have declined due to booming domestic demand and sharp increases in oil imports amid steep rises in crude oil prices, the capital account balances remains in the black, far exceeding India's current account deficit (RBI Report, 2005). This is mainly due to the influx of foreign investment through securities.

The main players in securities investment have been FDI and FIIs. The net amount invested by FIIs in India's stock markets in 2005 was about US$ 10.7 billion, up from the previous year's US$ 8.5 billion. This was a record high, topping US$ 10 billion for the first time. In addition to good business results and expectations for high economic growth, a substantial reduction in October 2004 in the capital gains tax for non-residents is the thought to have encouraged FIIs to invest more in Indian securities. Apart from the investments by FIIs, there has an increase in investments in the Depository Receipts (DRs) issued overseas by Indian companies. In January-October 2005, These investments totaled about US$ 1.6 billion (Bloomberg data), almost four times higher than the results for all of 2004 (about US$ 450 million). This reflects an increasingly active trend for Indian companies to procure funds in overseas stock markets because of their good business performance and consequent need to raise business fixed investment funds. In May 2005, in fact, Infosys Technologies, one of India's major IT companies, issued American Depository Receipts (ADRs) and procured about US$ 1 billion in Japanese and US stock markets. In November of the same year, ICICI Bank, India's largest private bank, raised about US$ 1.4 billion via a public offering of its shares, the largest amount ever procured by a private company in India.

In Japan also, here has been active investment in India through Indian stock investment funds. The first such funds in India were created in September 2004. As of the end of 2005, there were eights (excluding those that include Indian shares among their components, e.g. BRICs funds), with net assets rapidly growing to a total value of about ¥470 billion (Economic Research Office, Bank of Tokyo-Mitsubishi UFJ). Along with foreign investors, domestic investors also contributed greatly to the rising Indian stock prices as they stepped up their activities. Traded amounts-purchases and sales- in 2005 by domestic mutual funds both hit all time highs, and net investment reached about Rs.130 billion (about US$ 3 billion).

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