# Foreign Capital in India

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**Abstract**

Foreign capital is typically seen as a way of filling in gaps between the domestically available supplies of savings, foreign exchange, government revenue and the planned investment necessary to achieve developmental goals. In the era of globalization, there is a strong belief that foreign capital transforms the productive structures of developing economies leading to high rates of growth. Countries around the world have recognized foreign capital as a stimulant to economic development. Foreign capital permits a rate of investment, which is appreciably higher than the rate of domestic savings, in the case of scarce foreign exchange, which augments the country's capacity to import. It helps in industrialization in building up economic overhead capital and in creating larger employment opportunities. It opens up inaccessible areas and exploits untapped economic resources. India and almost all developing countries have opened their economies out of compulsion to achieve faster rates of economic growth and development. Besides the above, foreign capital by creating new productive assets contributes to the generation of employment a key need of a country like India. Overall foreign capital has a positive impact on the development of the Indian Economy.

**Keywords:** India, Foreign Capital, Economy, Development, Domestic, Investment, Need.

## Introduction

The term 'Foreign Capital' is a broad term that comprises any inflow of capital into one's home country from abroad. It may be in the form of foreign aid or loans and grants from the host country or an institution at the government level with foreign investment and commercial borrowings at the enterprise level or both. Foreign capital may flow to partner countries through technological collaboration.

Foreign capital plays an important role in all national economies regardless of their level of development. In developing countries, the accumulation and rate of investment are used to generate conditions for additional economic growth. Capital flows play a part in filling the resource gap in countries where domestic savings are insufficient to finance investment. Capital inflows are needed for macroeconomic stability as capital inflows control a large range of macroeconomic variables such as exchange rates, interest rates, foreign exchange reserves, domestic monetary conditions as well as savings and investment.

Foreign capital is the central element in the process of economic development and it is the primary means to achieve rapid economic growth. The flow of foreign capital is mutually beneficial to both the home country and the host country. For the home country, it is generating income through expanding business activities internationally and for the host country, it promotes production activities, boosts domestic exports and brings about long-run economic development.

In anticipation of the economic crisis on the one hand and the recognized importance of foreign capital in the economic development of the country on the other, the Indian government has been making continuous efforts to attract foreign capital in the post-liberalization period. Consequently, there has been a steady rise in the inflow of foreign capital and this has led to overall progress in various sectors of the Indian economy due to the continuous efforts of the government. In addition to that there has been progress in the field of employment, the standard of living, infrastructure development, health and hygiene, Gross Domestic Product and National Domestic Product due to foreign capital inflows in India.

Earlier in 1991, foreign firms were allowed to enter in the Indian market only based on their advance technology that was sans in India or the United States. More or less every aspect of production and marketing was controlled and many of the foreign companies that came to India eventually abandoned their projects.

The Indian government liberalized the inflow norm of foreign direct investment. The

government's policy permits foreign institutional investors to invest in Indian capital markets. The government is providing various incentives to NRIs to invest in India. Indian companies are allowed to obtain capital from foreign countries through 'Euro Issues' and 'Global Deposit Receipts'. India opened its pharmaceutical sector to 100% foreign direct investment via the automatic approval route in the year 2002.

**Need for Foreign Capital**

The majority of countries that embarked on the road to economic development had to depend on foreign capital. Foreign capital has been contributing in different ways to economic development. The need for foreign capital to increase domestic resources was felt by developing nations due to the growing variance between their capital requirements and their savings. Further many developing countries consider foreign capital an essential factor in their development policies through various forms of foreign assistance. The timely availability of external finance especially by way of foreign direct investment (FDI) in adequate amounts has become indispensable for sustained economic development in most developing countries of the world. FDI flows are generally preferred over other forms of external finance because they are not debt creating, non-volatile in nature and their returns depend upon the functioning of the projects financed by the investor. FDI would also make possible international trade and the transfer of knowledge, skills and technology.

The concept of FDI has become an essential element in the policies of many developing countries. World FDI flows have been increasing faster than other economic aggregates such as world production, the rate of capital formation and trade.

**Foreign Capital and Economic Growth**

India is following a well-trodden historic path in drawing upon the resources of the richer sections of the world to build-up its productive capacity and augments its economic and technical resources. Foreign capital permits a rate of investment, which is appreciably higher than the rate of domestic savings. In the case of scarce foreign exchange, it augments the country's capacity to import.

The Government of India has been making continuous efforts to attract foreign capital during the post-liberalization period. As a result, there has been a steady rise in the inflow of foreign capital leading to overall growth in various sectors of the Indian economy. In addition, there has been an improvement in employment, the standard of living, infrastructure development, health and hygiene, Gross Domestic Product and National Domestic Product due to foreign capital inflows in India.

**Foreign Capital before Liberalization**

The post-independence economic policy of India merged a strong private sector with state planning and control treated foreign investment as a basic evil. In the period ended with the 1980s, India maintained a selective approach to FDI. The selectivity in approach was governed principally by the objective of technology transfer and export promotion that the policymakers expected foreign capital to meet. Several measures were designed to maximize the perceived benefits from foreign investments while simultaneously keeping the costs low. However, the overall policy environment has also been considered a key factor in determining the low level of foreign investment in the country. The specific instruments of policy that were generally regarded as impediments to the increase of foreign capital in the country were: industrial licensing under the Industries Development & Regulation Act (IDRA) 1951 size consideration under the Monopolies & Restrictive Trade Practices Act (MRTPA) 1969. Controls on the level of foreign shares placed by the Foreign Exchange Regulation Act (FERA) 1973 high rates of taxation, restrictive labor laws and inadequate patent protection. Earlier in 1991, foreign firms were permitted to enter the Indian market only if they possessed technology unavailable in the Indian economy. Every aspect of production and marketing was heavily controlled and many of the foreign companies that came to India ultimately abandoned their projects. Foreign equity participation was limited to 40% and foreign investors were saddled with numerous operating constraints. Foreign equity investments above 51% or those, which fall outside the specified high priority areas, must be approved by the Foreign Investment Promotion Board (FIPB) and approved by a Cabinet Committee.

**Foreign Capital after Liberalization**

Globalization and the consequent introduction of a New Economic Policy were landmark achievements made by the supporters of the capitalist champions. The effects of the New Economic Policy are seen in foreign capital. The economic policies of 1991 proved to be a watershed in the economic history of India. The Indian government introduced a series of reforms in 1991 to liberalize and globalize the economy. These economic reforms are geared towards the market economy and the globalization of the economy. These economic reforms were intended to integrate the Indian economy with the global economy. Because of globalization in India, the process of dismantling trade barriers started in 1991 and every year the government has been announcing reductions in trade barriers. It is argued that this will enable the free flow of goods, capital and technology

and thus globalization will become a motivating force for economic growth. It also opened access to new markets and new technology. The Indian Government liberalized the inflow norm on foreign direct investments. The government is also allowing foreign institutional investors (FIIs) to invest in the Indian capital market. The government is providing various incentives to NRIs to invest in Indian economy. Now Indian companies are allowed to obtain capital from foreign countries through 'Euro Issues' and 'Global Deposit Receipts'. Apart from that India has opened its pharmaceutical sector to 100% foreign direct investment via the automatic approval route in 2002.

**Present Scenario of Foreign Capital**

Currently foreign direct investment is allowed via an automatic route except for a small list. 100% FDI is permitted in Special Economic Zones under certain conditions. 26% foreign equity participation is allowed in the insurance sector subject to a license from the Insurance Regulatory and Development Authority (IRDA). 100% FDI is allowed in the e-commerce and telecom sectors. At present FDI is only allowed up to 51% in single-brand retail and 100% in the wholesale cash-and-carry segment.

Now up to 100% FDI is allowed in realty projects with certain conditions such as a three-year lock-in on investments and a minimum capitalization of US$5 million. In mining the government allows 100% FDI through the use of an automatic route. Companies are allowed under the automatic route to bring in FDI into the country just by informing the Reserve Bank of India. The changes in FDI regulations are being considered in the wake of security concerns raised by the National Security Council.

**Composition of Foreign Capital Inflows in India**

India receives Foreign Capital in the following form:

**1. Foreign Investment**

Foreign investment is considered the major source of funds, which may contribute to the growth of developing countries. In recent years it has become evident that growing shares of the market punters are open to investment in India. The priority sectors in India such as banking, insurance, e-commerce, telecom etc. are believed to be the drivers of foreign investment in India. Foreign investment plays an important role in the long-term economic development of a country by augmenting the availability of capital, enhancing the competitiveness of the domestic economy through the transmit of technology, strengthening infrastructure, raising productivity, generating new employment opportunities and boost up exports. Therefore, foreign investment is a strategic instrument of a country's developmental policy.

In the wake of the economic liberalization policy initiated in 1991, the Government of India has taken several measures to encourage foreign investment in the domestic economy by foreign individuals or companies both direct and portfolio. India has consistently been considered one of the most attractive investment destinations by reputed international rating organizations. With a huge reservoir of skilled and cost-effective work force, India offers vast opportunities for Business Process Outsourcing (BPO), Knowledge Process Outsourcing (KPO) and Engineering Process Outsourcing (EPO). The legal, economic and financial reforms undertaken by the Indian Government since the early 1990s have resulted in the substantial and fast growth of the Indian economy and lead to the integration of the Indian economy into the international economy.

- **Foreign Direct Investment (FDI)**

Foreign Direct Investment is defined as a form of long-term international capital movement that is made for productive activity and is accompanied by the intention of managerial control or participation in the management of a foreign firm. Foreign direct investment is a form of investment that earns interest in enterprises that work outside the domestic country of the investor. Foreign direct investment is a part of a country's national financial account. Foreign direct investment is a leading driver for economic growth and brings substantial benefits to national economies. It can play a role in Gross Domestic Product (GDP), Gross Fixed Capital Formation (total investment in a host economy) and Balance of Payments.

The actual foreign direct investment inflow is recorded under seven heads: government (SIA\FIPB), Reserve Bank of India, acquisition of share routes, Non-Resident Indian (NRI) schemes, the equity capital of unincorporated bodies, reinvested earnings and other capital.

- **Foreign Portfolio Investment (FPI)**

Foreign portfolio investments are purely financial assets for example bonds denominated in a national currency. With bonds the investor merely provides capital to get fixed payouts or a return at regular gaps and then receives the face value of the bond at a pre-specified date. It is the entry of funds into a nation where foreigners make purchases in the country's stock and bond markets generally for speculation.

Foreign portfolio investment in India takes a variety of forms such as investment by Foreign Institutional Investors (FIIs), issuance of Global Depository Receipts (GDRs), abating of offshore funds by Indian Corporations abroad and those under special

investment schemes designed for Non-Resident Indians. Portfolio investments have favorable implications for overall market discipline and monitoring of economic fundamentals by both the authorities and market players. These aspects play a catalytic role in attracting foreign portfolio investment.

**2. External Commercial Borrowings (ECB)**

External Commercial Borrowing refers to the loans floated by financial institutions and public sector undertakings in external commercial markets. Thus external commercial borrowing is defined to include loans from commercial banks and other financial institutions, suppliers, credits, bonds and loans from semi-government export credit agencies. These loans are procured at a market rate of interest.

It is an instrument used in India to facilitate access to foreign money by Indian corporations and PSUs (Public Sector Undertakings) for financing expansion of existing capacity as well as for new investment to supplement the resources available domestically. ECBs can be used for any purpose (rupee-related expenditures as well as imports) apart from investment in the stock market and speculation in real estate. ECB contains commercial bank loans, Securitized Borrowings (IDBS and FCCBS), commercial borrowings from the private sector window of multilateral financial institutions like IMF, IBRD, International Finance Corporation, ADB, AFIC, CDC, self-liquidating loans etc.

**3. NRI Deposits**

The NRIs are permitted to freely acquire immovable property (other than agricultural land, plantations and farmhouses). There are no limits regarding the number of such properties to be acquired. The only restriction is that where the property is acquired out of inward remittances the repatriation is restricted to the principal amount for the two residential properties. There is no such restriction in respect of the commercial property. NRIs are also allowed to avail housing loans for purchasing a property in India and repayment of such loans by close relatives is permitted.

**4. External Assistance**

External assistance includes grants and loans obtained at low rates of interest with long maturity periods. Such assistance is generally provided on a basis or through multilateral agencies like the World Bank, International Monetary Fund (IMF), International Development Assistance (IDA) etc.

External assistance is the most vital component of foreign capital inflow into India. External assistance to India's planned economic development acted as a catalytic agent. The inflow of external assistance into India has been channeled through loans and grants.

- **Loans**

A loan is a form of debt and it requires the redistribution of financial assets evenly between the lender and the borrower. In a loan, the borrowers primarily collect or borrow an amount of money called the principal from the lender and are obligated to repay an equal amount of capital to the lender later. Typically, the money is paid back in regular installments or through partial repayments. Loans are generally repaid in terms of foreign currency but in certain cases, the donor may allow the recipient country to repay it in terms of its own currency.

- **Grants**

The grants are defined as 'something for nothing' that is given to the recipient country. It does not have any repayment obligations and is generally only available in the country through various foundations and international institutions.

- **Debt Service Payment**

The series of payments of interest and principal required on a debt over a given period of time is termed the debt service payment.

- **Foreign Aid**

Foreign Aid Foreign aid refers to the transfer of resources on concessional terms and conditions from the donor countries and multilateral institutions to the recipient countries. The receiving nation has no compulsion whatsoever to refund the grants made by the donor nation. Most developed countries give such aid to developing countries for their development planning. Generally, aids are given for a specific use and the recipient country must fulfill it.

**Factors Governing the Inflow of Foreign Capital**

The inflow of foreign capital is determined by a series of factors that include:

**The Rate of Interest**

The difference in the rate of interest between countries serves as a major stimulus to the inflow of foreign capital. Capital flows from countries where interest rates are low to those where interest rates are high because capital yields high returns.

**Bank Rate**

A stable bank rate for the Central Bank of a country influences capital inflows because market interest rates depend on it. Rising bank rates thus may stimulate the inflow of foreign capital.

**Marginal Efficiency of Capital**

Foreign investors generally compare the marginal efficiency of capital with the interest

rates in other countries and prefer to invest in those countries where the rate of return is likely to be higher.

**Production Costs**

Capital flow depends on production costs and local conditions. More capital tends to flow to those countries where labor, raw materials etc. are cheap and easily available.

**Political Stability**

The security of life and property friendly relations with other countries etc, encourage the inflow of foreign capital.

**Government Policies**

If the government is bent upon nationalization and extension of the public sector and adopts a hostile attitude towards foreign capital, foreign capital will not move into the country. If the government adopts an encouraging policy with respect to foreign capital, it induces an inflow of foreign capital into the country.

**Economic Climate**

The overall healthy economic position of the country, including its development of infrastructure, growth of financial institutions, availability of trained and skilled labor and other production facilities will play a significant role in attracting foreign capital from abroad.

**Business Conditions**

Capital will tend to flow from a country experiencing depression into a country that enjoys prosperity.

**Indian Government Policy towards Foreign Capital**

At the time of India's independence, the flow of foreign capital was not at all encouraging. The Industrial Policy of 1948 could not satisfy the foreign investor to invest in India. Thus to satisfy the foreign investor the Prime Minister of India Jawaharlal Nehru had to give the following three assurances:

a) there would be no discrimination between foreign capital and Indian capital;

b) provision would be made for remittance of profits or repartition of capital; and

c) provision for fair compensation would be made in case of nationalization of industries.

Despite all of these assurances, the flow of foreign capital was not enough.

Under Industrial Policy Resolution 1956, sufficient provision was made to increase foreign participation. Several tax concessions were made to encourage the flow of foreign capital. In 1972 the Government decided to permit fully owned subsidiaries of foreign companies provided they would undertake to export 100 percent of their output. In 1977

the Janta Party government encouraged the entry of foreign capital through collaboration in India. Various international companies were permitted to retain the equity of up to 51 percent or more.

Again, in July 1991 the New Industrial Policy was declared by the Government of India, which opened the doors of several industries for FDI. The Government revamped its foreign capital policy under its New Industrial Policy recognizing the increasing importance of foreign capital as an instrument of technology transfer, augmentation of foreign exchange reserves and globalization of the Indian economy. As per this industrial policy huge incentives and concessions were granted for the flow of foreign capital within the country. The main policy concessions available under this policy include:

a) Approving direct foreign investment of up to 51 percent equity in high priority areas;

b) Monitoring of payments of dividends to the RBI to ensure that the inflows through dividend payments are balanced with export earnings.

c) In order to provide access to international markets, most foreign equity holdings up to 51 percent equity will now be permitted in the trading companies most engaged in export activities.

d) To permit automatic approval for foreign investment with up to 51 percent equity in 34 industries.

e) To constitute a special empowered board for negotiating with various large international firms and approving direct foreign investment in select areas.

f) To hire foreign technicians and allow the testing of the indigenously developed technology in foreign countries without any prior permission.

The Foreign Investment Promotion Board (FIPB) was also set up to deal with applications in cases not cover up by automatic approval.

## Conclusion

In the Indian context, the role and importance of foreign capital have been required to speed up its future growth plans. The huge market size, availability of highly skilled human resources, sound economic policy, abundant and diversified natural resources all these factors enable India to make it a favorite destination for foreign investors. Foreign capital specially in the form of direct investment play an key role in the development process of the country and gives leverage to the Indian economy in achieving key objectives like rapid economic development, strengthening infrastructure, rising productivity, world-class technological competency, employment generation, removal of poverty and making its Balance of Payment favorable. Therefore, there is an urgent

need to adopt innovative policies and good corporate governance practices on par with international standards with the Government of India seeking to attract more and more foreign capital into various sectors of the economy to make India a developed economy on the map of the globe. The Indian government has been proceeding with economic reforms and is quietly working towards securing legislation to allow more foreign investment in various sectors of the economy. The amount of net capital inflows to India has increased significantly in the post-reform period.

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