



---

## Impact of FDI and FII on the Indian Economy

Chavada Baldevbhai Vinodbhai<sup>1</sup>, Dr. Prin. Jyotsnaben Patel<sup>2</sup>

<sup>1</sup> Assistant Professor, Government Commerce and Science College, Dahej, Ta. Vagra, Bharuch, India

<sup>2</sup> Gujarat Commerce College, Ahmedabad, Affiliated to Gujarat University, Ahmedabad, India

---

### Abstract

Any emerging economy may find foreign inflows as a blessing in disguise to spur the economic growth in its country by boosting production, income and employment as well as increasing the technological and the administrative efficiency. Since the landmark reforms in 1992, India has witnessed a prodigious amount of foreign inflows especially is the beginning of the 21<sup>st</sup> century, when it witnessed double-digit growth for most periods of time. However, the foreign inflows bring along with them, their curses, too. Theorists and economists have ever been arguing about the pros and cons and their implications of the Indian economy. The main argument against the foreign inflows is generally the introduction of instability in the Financial system. This paper focuses on the two major mediums of foreign investment in India: Foreign Direct Investment (FDI) and Foreign Institutional Investors (FII). The paper starts off defining FDI and FII. It also delves into the regulations and the legal statutes encompassing the rules and guidelines for each of them. It, thereafter, explains the major economic implications FDI and FII have on the Indian economy. Finally, it checks for any significant statistical relationships to corroborate the hypothesis that there does exist a statistically significant relationship between FDI/FII inflows and the market indices, which are assumed to be the representatives of the economic condition of the country.

**Keywords:** FDI, FII, Economy.

---

### Introduction

Being an emerging economy, India has, for long, been an attractive investment for foreign investors willing to invest monies in the Indian market. The gates for foreign investment were opened in 1991 when the then finance minister Manmohan Singh undertook the paradigm regime change under the economic liberalization policy. India has, ever since, attracted massive amount of foreign capital, mainly from the institutional investors and the multinational corporations abroad. The Indian Government classifies the foreign inflows into the following categories: Foreign Direct Investment (FDI), Foreign Institutional Investors (FII), and Non-residential Indian (NRI) and Person of India Origin (PIO) investments. Recently, there has been a lot of debate around the propositions of opening up the FDI gates in various sectors of the Indian economy and to increase the investment cap in the sectors where FDI already exists. Last two decades witnessed an intensely integrated globalization double-digit growth rate, which attracted prodigious amount of foreign capital especially in the first decade of the 21<sup>st</sup> century. But, the opponents of foreign inflows contend that the inflows may introduce increased volatility and instability in the Indian economy. Moreover, the Modi-led government also is mulling over easing the regulatory constraints in order to spur economic growth of the country. This paper, to a large extent, focuses on the implications of foreign capital on the Indian economy, through both FDI and FII. It, along with considering the importance of foreign inflows to expand the economy, also appraises the economic and social costs caused by the same.

### Research Methodology

The paper starts with defining the concepts of Foreign Direct Investment and Foreign Institutional Investment. Thereafter, it deals with the multitude of pros and cons of each of them and the social and economic implications of each on the economy. Moreover, it deals with the challenges in order to attain the desired objectives as regards the inflows in context of the incumbent dispensation. The regulatory oversight encompassing the inflows is also delineated. It, then, deals with the recent developments and current market trends and expectations in the context of FDI and FII. Various mathematical and statistical techniques are used to quantify the assertions and prove the relationships between the variables. Following are the quantitative techniques used:

**Correlation:** is the measure quantifying the direction and the magnitude of relationship between two variables. The measure of correlation is known as the correlation coefficient. It is bounded on both the sides by -1 and +1. Positive correlation ( $+1 > r > 0$ ) states that the two variables change in the same direction and negative correlation ( $-1 < r < 0$ ) states that the changes in the two variables take place in the opposite direction. Perfect positive correlation ( $r=1$ ) shows that the change in two variables is in the same direction and proportional. Perfect negative correlation ( $r=-1$ ) shows that the change in two variables is in the opposite direction and proportional.

Correlation tests are conducted between FDI/FII and the market indices to check for any correlation between the changes in the index and the FDI/FII inflows. Market Indices used to represent the economy are Sensex and Nifty. Sensex is the index comprising of 50 large-cap stocks traded on National Stock Exchange (NSE). Nifty is the index comprising of 30 large-cap stocks traded on Bombay Stock Exchange (BSE).

**Regression:** measures the change in the dependent variable based on the change in the independent variable. The Ordinary Least Squares (OLS) method is used to fit a regression line around the variables. FDI and FII inflows are taken as the independent variables and NIFTY and SENSEX values are considered as the dependent variables. Multiple regression is used to assess the joint effect of two or more independent variables (FDI and FII) on a single dependent variable (market indices).

**Data Collection:** The data for the Nifty and Sensex index values are collected from the BSE India and NSE India websites, respectively. Nifty and Sensex year-end values are calculated as the average of their daily ending values. This method is more efficient than just taking the year-end values, which ignore the intra-year changes in the indices. The FDI and the FII data are taken from various government repositories such as the RBI website, the MCA, and the Government of India.

**Foreign Direct Investment (FDI):** A Foreign Direct Investment (FDI) refers to a controlling ownership in a business enterprise in one country by an entity based in another country. A broad definition of FDI includes participating in an M&A, a joint venture with another investor or enterprise, incorporating a subsidiary, acquiring shares in an associated enterprise or expanding new facilities in a foreign country.

**Regulation:** FDI was introduced in India in 1991 under the Foreign Exchange Management Act (FEMA). FDI can be made through two mechanisms: 1. Automatic Route and 2. Government Route. FDI through Automatic Route doesn't require any approval from the government. However, FDI through Government Route does require obtaining an approval from the Foreign Investment Promotion Board (FIPB), a part of the Ministry of Finance. Other regulatory entities involved in the process are Secretariat for Industrial Assistance (SIA), Foreign Investment Implementation Authority (FIIA), Investment Commission, Project Approval Board and RBI.

**Current Scenario:** In the last two decades, India has been one of the top 5 countries in terms of FDI inflows. It has been attracting massive investments from countries like Mauritius, Singapore, the U.S., the Netherlands and Japan. Total FDI inflows into India in the period April 2000–August 2014 touched US\$ 341,357 million. The major sectors attracting FDI in India are infrastructure, automotive, retail and consumer products, technology, financial services and life sciences. India will require around US \$1 trillion in the 12th Five-Year Plan (2012–17), to fund infrastructure growth covering sectors such as highways, ports and airways. This requires support in terms of FDI. The year 2013 saw foreign investment pour into sectors such as automobiles, computer software and hardware, construction development, power, services, and telecommunications, among others. The incumbent government realizes the need for foreign capital in order to push for an economic expansion. Moreover, foreign investors have largely appreciated the political stability at the national level and the government seems to reciprocate by being determined to easing the regulatory constraints for the foreign investors to as large an extent as feasible. FDI is much more stable a source of inflows compared to FII as it is not easy to liquidate the investments in FDI and hence, it prevents sudden outflows during contraction periods. In its latest budget, the government increased the FDI limit in the insurance and the defense sectors to 49% subject to the management and control being retained by the domestic company. FDI limit is 49% for banking and infrastructure, 51% for multi-brand retail, and 100% for single-brand retail (49% through automatic route; 49-100% through FIPB).

### **Economic Implications**

- 1. Improved Macros:** Inflows improve the BoP position helping the capital account. Moreover, it also improves the current account position by aiding import substitution/export promotion.
- 2. Increased Exports:** Foreign investors are more adept at export-related practices. It helps in an increase in exports with the help of their cost-reducing dynamics as well as state-of-the-art technologies.
- 3. Improved Financial Stability:** FDI increases the government revenue in terms of taxes and import tariffs. They also invest in social/economic infrastructure and enhance the stability of the financial and marketing system. Moreover, they create a multiplier effect increasing the effectiveness in the soundness of the system.
- 4. Increased Technological and Managerial effectiveness:** Foreign capital brings, along with it, highly effective technologies and managerial effectiveness in terms of sound and efficient administrative practices.
- 5. Dominance of Organized Sector:** Introduction of FDI in the Indian economy may lead to an intensive restructuring resulting into the dominance of the organized sector. These results into the deterioration in the

standard of living of the population indulged in the unorganized market, which forms a major part in certain sectors.

6. **Worse-off Farmers:** As compared to today, when various ‘mandis’ compete to give the best price to the farmers for the procurement of the agricultural produce; the MNCs are always in a better position with an increased purchasing power as the purchasing side is concentrated amongst a few MNCs.
7. **Social/Cultural Changes:** Besides the economic implications, introduction of foreign investment in the country may revamp, to a large extent, the social and the cultural dynamics of the country.

### Foreign Institutional Investor (FII)

As per the Securities and Exchange Board of India (SEBI),

“An institution established or incorporated outside India which proposes to make investment in India in securities, provided that a domestic asset management company or domestic portfolio manager who manages funds raised or collected or brought from outside India for investment in India on behalf of a sub-account, shall be deemed to be a Foreign Institutional Investor.”

**Regulation:** The Government of India first opened the doors for FIIs in 1992 and issued guidelines for encompassing the entry and investment norms for investments in the Indian capital markets. The FIIs were required to seek SEBI’s permission prior to making any investments in the capital markets. Moreover, they had to seek RBI’s approval through SEBI. In 2005, SEBI issued SEBI (FII) Regulations, 1995, which are the primary guidelines framework as regards the registration and the investment norms for FIIs. Later, in December 2003, RBI waived the requirement of its approval under Foreign Exchange Management Act (FEMA).

**Current Scenario:** A quarter of India’s biggest companies are owned by foreign institutional investors (FIIs) with the value of their equity ownership standing at US\$ 315 billion. In the four years ended December 2013, they invested close to Rs 371,342 crore (US\$ 60.68 billion) in Indian stocks. India has been one of the most attractive investment destinations mainly because of its productive human capital and emerging economic dynamics. Moreover, FIIs have lately been pretty impressive about the emergence of political stability in India under the Narendra Modi-led political regime. Modi government has been quite active in relaxing compliance procedures and approval-seeking procedures involved in the inflows of foreign capital. This has greatly enhanced the foreign investors’ eagerness to pump in more monies in the Indian economy. During FY14, FIIs invested a net amount of nearly Rs 80,000 crore (US\$ 13.07 billion) into India’s equity market, as per data by Securities and Exchange Board of India (SEBI). Overseas investors invested US\$ 20.4 billion into the Indian market in the first half of 2014, primarily on hopes of a stable government. Foreign net investments into equity markets stood at US\$ 9.96 billion during January–June 2014, while investments for debt markets stood at US\$ 10.4 billion, as per industry data.

### Economic Implications

1. **Stock Market Reforms:** FIIs can be considered both the cause and the effect of stock market reforms like improved market transparency, automation, dematerialization and regulations on reporting and disclosure standards. These reforms were brought in the first place because of the existence of FIIs and it turned out to attract more FII inflows due to more efficient norms.
2. **Improving Allocational Efficiency:** FIIs are generally managed by astute fund managers which, after a considerable amount of research, invest the amounts in highly profitable projects and firms thus allocating the economic capital towards the most profitable sectors of the economy. This increases the allocational efficiency of the capital markets and thus bolsters the economic development of the country.
3. **Enhanced Equity Inflows:** FIIs generally have an inclination towards allocating major proportions of their portfolios towards equity instruments. Being an emerging economy, this increases the ease of funding for efficient projects having considerable growth potential. This, in turn, leads to better production, income and employment in the country.
4. **Effective Corporate Governance:** Corporate powerhouses often indulge in fraudulent activities which further exacerbate the principal-agent conflict. This can be improved by framing an appropriate corporate governance framework in the organization. It is considerably more difficult for the executives to ignore corporate governance when a major portion in the company is held by FIIs because FIIs are generally much more prudent investors than retail investors.
5. **Inflation:** Huge inflows of FIIs increase the money supply in the economy thereby increasing the amount of money chasing limited goods. This over-shoots liquidity in the market, thereby increasing inflation in the economy. Inflation damages the purchasing power of the savings and the investments of the country. The host country generally counters this through tighter monetary policy.

6. **Detrimental to Exports:** A large amount of FII inflows increases the demand for the Indian Rupee, thereby leading to an appreciation of the Indian Rupee. This makes the Indian goods more expensive for the foreign buyers compared to other exporters like China. Therefore, this may lead to an adverse impact of the country's exports, which may, in turn, disrupt the current account balance of the economy.
7. **Increased Volatility:** FIIs are considered to be 'Hot Money'. Hot Money refers to the funds that seek out for high, short-term returns in the emerging markets. This provides easy funding to projects having growth potential. However, when these funds are suddenly injected out of the economy, the financial system experiences a sudden slump in liquidity which causes a surge in the volatility and instability of the financial system of the country.

## Statistical Conclusions

### Correlation

Data for FDI inflows, FII inflows, Average Sensex and Nifty values were collected from various bulletins of the RBI and BSE India and NSE India data repositories, respectively for the time period ranging from 2000 to 2011. Correlation tests and the respective hypothesis tests were conducted using Microsoft Excel. Following are the correlation coefficients observed:

**Table 1**

	<b>FDI (US\$ mn)</b>	<b>FII (US\$ mn)</b>	<b>BSE (Sensex)</b>	<b>NSE (Nifty)</b>
FDI (US\$ mn)	1	0.273	0.907	0.907
FII (US\$ mn)	0.273	1	0.568	0.573

This shows positive correlation between the FDI/FII inflows and the change in the market indices for the corresponding period. The relation between FDI & Sensex and FDI & Nifty is significant at 1% significance level. However, the correlation between FII & Sensex and FII & Nifty isn't significant at 1% significance level.

### Regression

Multiple Regression Ordinary Least Squares is used taking BSE Sensex as the dependent variable and FDI and FII inflows as the independent variables. R-squared, which reflects the goodness of fit for the regression line defines the proportion of variation in the dependent variable explained by the independent variable. R-squared can be calculated as the square of the correlation coefficient. R-squared is 93% for the multiple regressions. This states that 93% of the variation in BSE Sensex is caused by the variation in FDI and FII inflows. This shows a robust significance of relationship between the foreign inflows and the market indices. The p-value, being close to zero, F-stat is significant at the 5% significance level.

### References

1. Jain M, Meena Priyanka, Mathur TN. 'Role of FDI and FII in Indian Economy, TRANS Asian Research Journals, 2013, 2(3).
2. Rao KM, Rani HR. 'Impact of Foreign Institutional Investments on Indian Capital Market', International Journal of Marketing, Financial Services & Management Research, 2013, 2(6).
3. Sultana ST, Pardhasaradhi S. 'Impact of Flow of FDI & FII on Indian Stock Market', Finance Research, 2012, 1(3)
4. Loomba J. 'Do FIIs impact volatility of the Indian Stock Market?' International Journal of Marketing, Financial Services & Management Research, 2012, 1(7).
5. www.ibef.org
6. www.rbi.org.in
7. www.bseindia.com
8. www.nseindia.com