TOM JACOB "IMPACT OF FOREIGN INVESTMENT FLOWS ON INDIAN ECONOMY IN THE POST LIBERALISATION ERA." THESIS. RESEARCH DEPARTMENT OF COMMERCE ST THOMAS' COLLEGE (AUTONOMOUS), UNIVERSITY OF CALICUT, 2019.

Chapter 2

Review of Literature

Capital has always been the pivot on which economies, economics and economists revolve. In fact Adam Smith's 'Wealth of Nations', is a treatise on capital where he gives great importance to capital by considering capital as one of the factors of production and examines the functions of capital in detail. The epoch making work of Karl Marx, 'The Das Capital' which examines the past, the present and the future dimensions of capital and capitalism, is prophetic in nature as he predicts the flow of capital beyond the national boundaries.

By the end of the 18th century, as fortold by Marx, capital began to flow beyond the national boundaries as an integral part of colonialism. The colonial powers competed among themselves to make investments in their colonies. Such foreign investments, though may be the predecessor of the present day foreign investment, were entirely different from the present one as the receiving countries had no say in such investments. It was some sort of an imposed foreign investment made with the political and theoretical backup and justification. Several works appeared justifying such imposed foreign investment. The theme of them was the justification of foreign investment as an attempt to make the uncivilised world civilised Niti (2012)[10], Arockia and Soundararaj (2009)[11].

[10] Niti, B. (2012). *Foreign Direct Investment in India: Policies, Conditions and Procedure.* New Century Publication, New Delhi.

[11] Arockia B., and Soundararaj J.J. (2009). *The Impact of Foreign Direct Investment on Indian Economy*, Excel Publications, New Delhi.

When nationalism emerged throughout the world and colonialism began to be questioned and threatened, a lot of works appeared supporting nationalism, attacking foreign investment, emphasizing 'swadeshi movement'. By the middle of the 20th century, criticism of foreign investment became the order of the day. Naoroji (1901)[12] was the prominent member of this school of thought. But in the latter half of the 20th century with the advent of globalization and its corollaries, a series of works appeared justifying as well as opposing foreign investments. These works can be classified under the following heads as per the relevance of the study.

2.1 Studies Related to Foreign Direct Investment (FDI)

Within the field of foreign investment, when compared to Foreign Portfolio Investment (FPI) it is Foreign Direct Investment (FDI) which attracted more scholarly attention all over the world. Several researchers tried to explain the theory of FDI and came up with its different concepts. In 1966 Raymond Vernon proposed the production cycle theory in which he identifies four stages of production i.e., innovation, growth, maturity, and decline. According to him FDI occurs during the second stage i.e., growth phase, with the motive of ensuring market share abroad (Vernon, 1966)[13]. Nayak and Choudhury (2014)[14] put forward a new argument. According to them FDI will take place only in an imperfect market where monopoly and oligopoly exist. They argue that a perfect market is not conducive for FDI because of the presence of a large number of sellers and buyers, absence of government intervention etc. According to Denisia (2010)[15], the macroeconomic perspective on FDI is that FDI itself is a type of cross border capital flow between home and host countries, and is reflected in the balance of payments statement of countries.

[12] Naoroji, D. (1901). *Poverty and Un-British Rule in India.* Commonwealth Publishers. Ministry of Information and Broadcasting, Patiala.

[13] Vernon, R. (1966). International Investment and International Trade in the Product Cycle. *Quarterly Journal of Economics*, 80(2), 190-207.

[14] Nayak, D., and Choudhury, R. N. (2014). *A Selective Review of Foreign Direct Investment Theories, Asia - Pacific Research and Training Network on Trade.* ARTNET Working Paper Series, No. 143, Bangkok.

[15] Denisia, V. (2010). Foreign Direct Investment Theories: An Overview of the Main FDI Theories. *European Journal of Interdisciplinary Studies*, 2(2), 53-59.

Another macroeconomic theory identified in the study, carried out by Lipsey (2004)[16], is the dynamic macroeconomic FDI theory. According to this theory, the timing of foreign direct investments depends on the changes in the macroeconomic environment. The macroeconomic environment consists of gross domestic product, domestic investment, the real exchange rate, productivity and openness. According to him these are some of the factors that influence the FDI flows into a country. This theory further affirms that FDI is a long term function of multinational companies and duration of time plays an important role in this function. The timing of investment will depend on the macroeconomic environment that is the political environment, the inflation rate, exchange rate, interest rate, market size, government policies etc. at that particular period in the host country as well as its degree of openness, rate of economic development, risk perceptions etc. Therefore it is important for a foreign investor to analyze and understand the investment environment of a country, the risks associated with the investment environment, the effect of various variables etc. will be different in different countries and economic environments.

Another area of literature is related to the determinants of FDI. Chawla and Rohra (2015)[17] considered economic growth rate (GDP) of the host country as a crucial factor for attracting FDI. According to them GDP is an indication of a country's ability to produce and consume and acts as a factor to attract foreign investors. Several others are of the same opinion. Mottaleb and Kalirajan (2010)[18] studied a sample of 68 developing countries for a period extending from 2005-2007 and found that there is a positive relationship between market size and FDI. According to them market size of the host country is a very important factor for potential investors. Therefore they argue that GDP growth rate can be considered as the growth of market potential. A growing market would increase the prospects of market potential and a large market size would generate economies of scale. Nair-Reichert and Wienhold (2001)[19] mainly fo-

[16]Lipsey, R.E. (2004). Home-and Host-Country Effects of Foreign Direct Investment in Challenges to Globalization: Analysing the Economics, University of Chicago Press, 333-382.

[17]Chawla, K., and Rohra, N. (2015). Determinants of FDI: A Literature Review. *The International Journal of Business & Management*, 3(3), 227-250.

[18]Mottaleb, A. K., and Kalirajan K, (2010). Determinants of Foreign Direct Investment in Developing Countries: A Comparative Analysis. *The Journal of Applied Economic Research*, 4(4), 369-404.

[19]Nair-Reichert, U., and Wienhold, D. (2001). Causality Tests for Cross-Country Panels: A New Look at FDI and Economic Growth in Developing Countries. *Oxford Bulletin of Economics of Statistics*, 63(2), 153-171.

cused on the causality running from FDI to GDP. The two-way link between FDI and GDP indicates that increased FDI promotes growth in host countries, similarly brighter growth prospects in the host countries attract an increased flow of FDI. According to Ivohasina and Hamori (2005)[20] return on capital is the dominant determinant of FDI. It is after conducting research among a sample of developing countries over the period of 1980-2001, they put forward this argument. Their finding is that capital scarce countries attracted comparatively good quantity of FDI because of the chances of highest return on the capital.

Another set of scholars emphasize exchange rate as a determinant of FDI. Udomkerdmongkol et al. (2009)[21] examined the impact of exchange rate on 16 host countries by US foreign direct investment over the period of 1990-2002. Their argument is that devaluation of the host economies reduce the cost of investment in these countries and hence profitable for investors. Their findings show that exchange rate devaluation is positively associated with US FDI flows and attributed this relationship to the fact that devaluation lowers the cost of investment in host countries for US foreign investors. At the same time according to Banga (2003)[22] volatility of exchange rate adversely affects the foreign direct investment. High volatility of exchange rate indicates uncertainty regarding the future economic and business aspects of the host country. Ellahi (2011)[23] also examined the behaviour of foreign direct investment flows in relation to the volatility of exchange rate and support the above view i.e., exchange rate volatility has negative effect on FDI flows.

Drake and Caves (1992)[24] found that fluctuations of exchange rate have an adverse impact on FDI. According to them the fluctuation of exchange rate is an indication of the instability of the currency of a country. However

[20]Ivohasina, R., and Hamori, S. (2005). An Empirical Analysis of FDI Competitiveness in Sub-Saharan Africa and Developing Countries. *Economics Bulletin*, 6(20), 1-8.

[21]Udomkerdmongkol, M., Morrissey, O., and Gorg, H. (2009). Exchange Rates and Outward Foreign Direct Investment: US FDI in Emerging Economies. *Review of Development Economics*, 13(4), 754-764.

[22]Banga, R. (2003). *Impact of Government Policies and Investment Agreements on FDI inflows*, Working Paper, No.116, Indian Council for Research on International Economic Relations, New Delhi.

[23]Ellahi, N. (2011). Exchange Rate Volatility and Foreign Direct Investment Behaviour in Pakistan: A Time Series Analysis with Auto Regressive Distributed Lag Application. *African Journal of Business Management*, 5(29), 116-125.

[24]Drake, T.A., and Caves, R.E. (1992). Changing Determinants of Japanese Direct Investment in the United States. *Journal of Japanese and International Economics*, 6(1), 228-246.

it is not an absolute condition; the influence of exchange rate upon the FDI depends on the quantity of the export of the country and the motives of the investment. They conclude that exchange rate uncertainty tends to delay the FDI activity of a market-seeking firm and it may accelerate the FDI activity of an export-substituting firm if the degree of risk aversion of the firm is high enough. Therefore, the results reveal that the relationship between exchange rate uncertainty and FDI crucially depends on the motives of the investing firms. Lower exchange rate in the host country means higher purchasing power of investing country's currency in the host country. Nyarko et al. (2011)[25] investigated the effect of exchange rate regime on FDI in Ghana over the period 1970-2008 and found an insignificant relationship between FDI and exchange rate. According to them it is because of the efforts of the policy makers in Ghana to stabilise the exchange rate as tool for attracting FDI.

The role of inflation of the host countries in attracting FDI is also studied by some writers. Ahn et al. (1998)[26] argued that there is a negative relation between FDI and inflation. Their argument is that higher rate of inflation is an indication of poor economic management or poor macroeconomic policies, which will repel foreign investors. Studies made by Frenkel et al. (2004)[27] and Mohamed et al. (2010)[28] agree with this finding. According to them high rate of inflation discourages FDI because high rate of inflation indicates some potential economic risks like deterioration of the real value of investment, return on investment etc. and thus discourage investments. According to Wheeler and Mody (1992)[29] economic stability of host country is a decisive factor in attracting FDI and there is negative relationship between foreign direct investment and inflation. It follows that low inflation of the host country is a necessary condition to promote FDI.

[25] Nyarko, P.A., Nketiah-Amponsah, E., and Barnor, C. (2011). Effects of Exchange Rate Regimes on FDI Inflows in Ghana. *International Journal of Economics and Finance*, 3(3), 277-286.

[26] Ahn, Y.S., Adji, S.S., and Willett, T.D. (1998). The Effects of Inflation and Exchange rate Policies on Direct Investment to Developing Countries. *International Economic Journal*, 12(1), 95-104.

[27] Frenkel, M., Funke, K., and Stadtmann, G.(2004). A Panel Analysis of Bilateral FDI Flows to Emerging Economies. *Economic Systems*. 2(2). 281-300.

[28] Mohamed, S. E., and Sidiropoulos, M.G. (2010). Another Look at the Determinants of Foreign Direct Investment in MENA Countries: An Empirical Investigation. *Journal of Economic Development*, 35(2), 75-95.

[29] Wheeler, D., and Mody, A. (1992). International Investment Location Decisions. The Case of US Firms. *Journal of International Economics*, 33(1-2), 57-76.

There are some studies which point out the influence of trade policies especially free trade and trade volume of the host countries on the FDI flows. A significant positive relationship of FDI with international trade volume has been found in the studies of Asiedu, (2002)[30] and Gastanga et al. (1998)[31]. Baharom et al. (2008)[32] studied the relationship between trade openness and FDI in influencing the economic growth of Malaysia using the Bounds Testing Approach. They found that there is positive relationship between FDI and trade openness which in turn encourages the economic growth. According to them the more the trade openness the more will be the FDI flows to the host countries and their economic growth. Trade openness also plays major role in pulling FDI into a country. Scaperlanda (1992)[33] also pointed out that the relationship between trade openness and FDI is positive. Ekpo (1995)[34] examined the factors like higher profit from investment, low labour and production cost, political stability, enduring investment climate, functional infrastructure facilities and constructive regulatory atmosphere and argue that these factors help to attract and preserve FDI in the host country.

Foreign direct investment has a significant positive impact on economic growth of developing countries but the magnitude of the impact is dependent on the conditions and characteristics of the host country (Bengoa and Sanchez-Robes 2003)[35]. Tiwari and Mutasque (2011)[36] scrutinized the relationship between FDI and GDP of Asian countries by using Panel Data Approach of 23 countries for the time period of 1986-2008. The results of study show that FDI and export have significant impact on the growth of economy. Jayachandran (2012)[37] investigated the relationship among trade, foreign direct investment

[30]Asiedu, E. (2002). On the Determinants of Foreign Direct Investment of Developing Counties: Is Africa Different?. *World Development*, 30(1), 107-119.

[31]Gastanaga,V. M., Jeffrey, B. N., and Pashamova, B. (1998). Host Country Reforms and FDI Inflows: How Much Difference Do They Make?. *World Development*, 26(7), 1299-1314.

[32]Baharom, A. H., Muzafar Shah, H., and Royfaizal, R. C. (2008). *The Relationship between Trade Openness, Foreign Direct Investment and Growth: Case of Malaysia*, MPRA Paper No. 11928, University Library of Munich, Germany.

[33]Scaperlanda, A. (1992). Direct Investment Controls and International Equilibrium: The US Experience. *Eastern Economic Journal*, 18(2), 157-170.

[34]Ekpo, A.H. (1995). Foreign Direct Investment in Nigeria: Evidence from Time Series Data. *CBN Economic and Financial Review*, 35(1), 59-78.

[35]Bengoa, M., and Sanchez-Robles, B. (2003). Foreign Direct Investment, Economic Freedom and Growth: New Evidence from Latin America. *European Journal of Political Economy*, 19(3), 529-545.

[36]Tiwari, A. K., and Mutascu, M. (2011). Economic Growth and FDI in Asia: A Panel Data Approach. *Economic Analysis and Policy*, 41(2), 173-188.

[37]Jayachandran, G. (2012). FDI, Trade and Economic Growth in Singapore-Evidence from Time-Series

and gross domestic product of Singapore during 1970- 2010. This study reveals a general positive co-relationship among trade, foreign direct investment and economic growth.

There are some other scholars who accept the impact of FDI on economic growth conditionally. Marta and Robles (2002)[38] studied the relationship of FDI and economic growth using the data of 18 Latin American countries for the period of 1970-1999 using Panel Data Approach. According to them if the size of the market of the host countries is sufficiently large, has developed human capital and economic stability, there is a positive relationship between FDI and economic growth of host country. In their article "Impact of Foreign Direct Investment on Economic Growth in Pakistan" Younus et al. (2014)[39], argued that there is a positive relation between economic growth and FDI. Their study was conducted using Two Stage Least Squares Method of Simultaneous Equations Estimation by taking GDP and FDI. Their study also found that the major determinants of FDI are the export size, domestic investment and political stability of the host countries. They recommended that governments of the host countries should frame suitable policies to attract FDI. Zhang (2001)[40] using econometric techniques such as Co-integration Tests and Error Correction Mechanism analyses the data from 11 countries in East Asia and Latin America and argues that FDI promotes economic growth only in countries with a liberalized trade regime and a work force with higher job skills and education.

Similarly, Hermes and Lensink (2003)[41] argue that improvement of the financial structure of the host economy is a pre-condition for the boosting of the economic growth by the FDI. Out of the sixty seven countries studied FDI made positive contribution only in the case of thirty seven countries. According to them these thirty seven countries could achieve economic growth mainly because of their developed financial structure. Therefore they suggest the im-

Causality Analyses. *Journal of Research in Commerce*, IT & Management, 2(9), 66-70.

[38]Marta, B., and Robles, B. (2003). Foreign Direct Investment, Economic Freedom and Growth: New Evidence from Latin America. *European Journal of Political Economy*, 19(4), 529-545.

[39]Younus, H., Amir,S., and Azeem, M. (2014). Impact of Foreign Direct Investment on Economic Growth in Pakistan. *World Journal of Economic and Finance*, 1(1), 002-005.

[40]Zhang, K.H (2001). Does Foreign Direct Investment Promote Economic Growth? Evidence from East Asia and Latin America. *Contemporary Economic Policy*, 19(2), 175-85.

[41]Hermes, N., and Lensink, R. (2003). Foreign Direct Investment, Financial Development and Economic Growth. *The Journal of Development Studies*, 40(1), 142-163.

provement of the domestic financial structure of the host economies before permitting FDI.

Baharumshah and Thanoon (2006)[42] by using Dynamic Panel Models demonstrated the positive contribution of FDI on the growth process of East Asian economies. Atique et al. (2004)[43] evaluated the economic growth of Pakistan using Eangle Granger and Hansen Methods. They found that the impact of FDI on the economy is higher than the impact of export of the economy and come to the conclusion that FDI played a significant role in the economic growth of Pakistan.

Yousaf et al, (2008)[44] studied the impact of FDI on Pakistan economy using Error Correction Model and Co-integration Techniques. Gudaro et al. (2010)[45] also studied the impact of FDI on the economic growth of Pakistan covering the data for the period of 1981-2010. They consider GDP as a dependent variable while FDI and CPI as independent variables. Their finding using Regression Model is that the relationship between these variables is significant and there is a positive effect of FDI on economic growth and negative relationship between inflation and GDP. Abbas et al. (2011)[46] examined the impact of FDI on the economic growth of the SAARC countries employing Multiple Regression Models and taking GDP as a dependent variable and FDI and inflation as independent variables. They found that while there is a positive and significant relation between GDP and FDI, there is only insignificant relation between GDP and inflation. According to them GDP of the host country is reflected in its purchasing power and its market size is the most important factor which attract FDI. Scaperlanda and Maurer (1969)[47] studying the economies of the several developing host countries argue that there is a positive relation between market size and FDI.

[42]Baharumshah, A.,and Thanoon, M. (2006). Foreign Capital Flows and Economic Growth in East Asian Countries. *China Economic Review*, 17(1), 70-83.

[43]Atique, Z., Ahmad, M. H,. and Azhae, U. (2004). The Impact of FDI on Economic Growth under Foreign Trade Regimes: A Case Study of Pakistan. *The Pakistan Development Review*, 43 (4), 707-718.

[44]Yousaf, M. M., Hussain, Z., and Ahmad, N. (2008). Economic Evaluation of Foreign Direct Investment in Pakistan. *Pakistan Economic and Social Review*, 46(1), 37-56.

[45]Gudaro, A. M., Chhapra, I. U., and Sheik, S. A. (2010). Impact of Foreign Direct Investment on Economic Growth: A Case Study of Pakistan. *Journal of Management and Social Sciences*, 6(2), 84-92.

[46]Abbas, Q., Akbar, S., Nasir, A., Amanullah, H., and Naseem, M. (2011). Impact of Foreign Direct Investment. *Global Journal of Management and Business Research*, 11(8), 143-157.

[47]Scaperlanda, A., and Maurer, L. (1969). The Determinants of US Direct Investment in the EEC. *American Economic Review*, 59(2), 558-568.

In their study Nair-Reichert and Wienhold (2001)[48] besides establishing the relationship between FDI and GDP argue that there is a two way relationship between GDP and FDI. i.e., on the one side increase in FDI promotes growth of the host countries and on the other side increase in the growth of the host countries attract more FDI. Stehrer and Woerz (2009)[49] examine the effect of FDI on the output growth of the host country by selecting OECD and non-OECD countries are sample for the period 1981-2000. The results suggest a positive relationship between FDI and output growth as well as productivity and export. Another area related to the impact of FDI is the foreign trade. One main study in this area was conducted by Qayyum and Mehmood (2013)[50]. From their study on Pakistan economy they find that there is a mutual relationship between FDI and foreign trade i.e., they are of the opinion that FDI promotes foreign trade.

FDI in India also received serious attention from the scholars. It may be because of the drastic policy deviation. Though the Nehru Resolution of 1949 permitted FDI under certain severe restrictions, generally India was strictly against foreign investment before liberalization. But as mentioned earlier it was the economic reforms in the 1990s which paved the way for FDI in India. These reforms not only lifted the restrictions imposed by Nehru Resolution but also framed policies in favour of FDI. In fact it was certain theoretical works which prepared India for economic reforms and foreign investment. One such work was by Sharma (1987)[51]. He presents a case for a new foreign investment statute in India. The study argues that since foreign direct investment has to be encouraged and regulated, it is necessary to have a positive investment climate. The foreign investor should be clear in which field his investment is welcome; what the criteria for allowing foreign investment are; which is the proper regulatory agency and what are their powers; the time frame in which the project will be accepted or rejected and the penalties for the violation of laws

[48]Nair-Reichert, U., and Wienhold, D. (2001). Causality Tests for Cross-Country Panels: A New Look at FDI and Economic Growth in Developing Countries. *Oxford Bulletin of Economics of Statistics*, 63(2), 153-171.

[49]Stehrer, R., and Woerz, J. (2009). Attract FDI - A Universal Golden Rule? Empirical Evidence for OECD and Selected non-OECD Countries. *European Journal of Development Research*, 21(1), 95-111.

[50]Qayyum, U., and Mahmood, Z. (2013). *Inter-linkage between Foreign Direct Investment and Foreign Trade in Pakistan: Are They Complements or Substitute?.* Working Papers No. 91. Pakistan Institute of Development Economics Islamabad, Pakistan.

[51]Sharma, K. A. (1987). Case for a New Investment Statute. *Foreign Trade Review*, 22(1) 83-94.

dealing with foreign investment etc. It also recommends simple and streamlined procedures, clarity, comprehensiveness and promptness etc. to create a positive investment climate. According to him these objectives can be achieved through a new investment law dealing with all the above issues, which at present lie scattered in different statutes, regulations, circulars and guidelines.

Similarly Ghoshal (1990)[52] noticed some of the draw backs of India's FDI policy. According to him emphasise on indigenisation of industries, procedural delays and complications etc. of FDI policy repel large scale foreign investment in India despite policy relaxation allowing foreign investment. However he emphasises the need for foreign investment in India and advanced technology for economic growth and modernisation of the Indian economy. Bhattacharya (1994)[53] also supported the view of Ghoshal to a certain extent. According to him FDI policy of India cannot be the major or the only deciding factor in foreign investment. He gave equal importance to the availability of reliable knowledge and information about the business climate of India. According to him this is necessary because till recently India was known as a foreign investment opposing country. In other words government should give enough propaganda about the policy changes and the potential of Indian market. He also emphasises the need to achieve stability in the political and economic system as a prelude to foreign investment in India.

Prasad (1994)[54] also supported the above views. According to him along with liberalization policy, discriminative incentives for investment in the desired sectors by desired countries should be given. In his opinion liberalization must be an ongoing process and the critics of foreign investment can be silenced by the proper utilization of foreign investment, especially by acquiring new technology, by strengthening the domestic companies etc. Mani and Baker (1997)[55] made a SWOT analysis FDI and Indian economy. They argued that India's climate, an almost developed stock market, developed financial system, well developed infrastructure, qualified manpower, a vast market for consumer goods etc. are

[52]Ghoshal, M.K. (1990). Foreign Investment in India: Policy Lessons and Prospects, *Yojana*, 34(8), 17-19.

[53]Bhattacharya, B. (1994). Foreign Direct Investment in India. *Foreign Trade Review*, 28(4), 307-329.

[54]Prasad, A.C. (1994). Foreign Direct Investment in India: Some Basic Facts and Issues. *Foreign Trade Review*, 28(4), 307-329.

[55]Mani, U. H., and Baker J.C. (1997). Foreign Direct Investment in India: Problems and Prospects. *Foreign Trade Review*, 32(1), 16-28.

the strength of the Indian economy to receive and accept FDI. At the same time India's bureaucracy, delay in decision making, strong criticisms against multinational companies etc. are the unfavourable conditions of FDI in India.

Naga Raj (2003)[56] in his article presented the trends in FDI in India. He also compared FDI inflow in India with that of China. Based on the result of this descriptive analysis and comparative study, he suggests that a more realistic foreign investment policy framework is required to expect increased flow of FDI into India. Bajpai and Jeffrey (2006)[57] identified the issues and problems associated with India's FDI regimes in their paper on "Foreign Direct Investment in India: Issues and Problems". They observed that despite the favourable factors there are some unfavourable factors like restricted FDI regime, high import tariffs, exit barriers for firms, stringent labour laws, poor quality infrastructure, centralized decision making processes and a very limited scale of export processing zones etc. which deter free flow of FDI into India.

Sahni (2009)[58] argues that since FDI plays a major role in the economic growth of the developing countries it is very necessary for the emerging markets like India to frame policies to attract FDI. This paper also studied the trend of FDI in India and sector-wise economic reforms. The study of Mathur (2001)[59] provides a comprehensive view of the changes in India's foreign trade policy during the post liberalisation period from 1991-2001.The first part of this study examines the trade policy system during the pre-liberalisation period and the balance of payment crisis in India during that period. The study also presents a sectoral analysis of foreign investment and specifically highlights the foreign investment opportunities in the promising sectors of Indian economy like power, oil and natural gas, infra-structure, telecommunication etc. Bodla and Bhati (2004)[60] also observes the major changes taking place in the FDI in India. They observe the gradual decline of US monopoly in India and the advent of several developed western FDI into India. This study also no-

[56]Nagaraj, R. (2003). Foreign Direct Investment in India in the 1990s: Trends and Issues. *Economic and Political Weekly*, 38 (17), 1701-1712.

[57]Bajpai, N., and Jeffrey, D.S. (2006). *Foreign Direct Investment in India: Issues and Problems.* Paper No. 759, Harvard Institute of International Development, Development Discussion Cambrige.

[58]Sahni, P. (2012). Trends and Determinants of Foreign Direct Investment in India: An Empirical Investigation. *International Journal of Marketing and Technology*, 2(8), 144-161.

[59]Mathur, V. (2001), *Trade Liberalisation and Foreign Direct Investment in India 1991-2000.* New Century Publications, New Delhi.

[60]Bodla. B.S, and Bhati, U. (2004). FDI: Emerging Scenario. *Yojna*, 48(4), 21-27.

ticed the difference between FDI approvals and the actual realization, uneven distribution of FDI in the different states of India etc. citing the example of Maharashtra which received 19 percent of total FDI and Bihar and Himachal Pradesh which received the least, just 0.29 percent and 0.45 percent of the total FDI approved. This study also analysed sector wise break-up of FDI and technical collaboration approved. It showed that energy sector is on the top with 26 percent of total FDI approved, the telecommunication sector with 19 percent, and electric equipment with 9.33 percent come next. Kumar (1998)[61] examined the trends in FDI inflows to India in the wake of policy reforms initiated since 1991 and confirmed the magnitude of FDI inflows has recorded an impressive growth. The policy reforms have enabled the country to widen the sectoral as well as the source country composition of FDI inflows.

Unlike the above scholars Majumdar and Chhibber (1998)[62] made some sort of an evaluative study. By taking around 1000 firms with foreign investment during the period from 1999-2004, they find that the impact of FDI in these firms is not uniform with regarding their export performance. They observe that the higher the degree of foreign control and ownership, the higher will be the export performance. It follows that foreign firms wishing to enlarge their global market must invest in India in such a way that they will get control over the firm. They also suggest that in order to get the full benefit of FDI full foreign control over firms should be permitted.

Srivastava (2003)[63] explored a new aspect of FDI i.e. difference in the definition of FDI and interpretations. In this attempt he tried to prove that India is not an under performer when compared to China and Asia as usually projected. According to him there are some differences in the definition of FDI and the interpretation of FDI data. The definition of FDI and computation of FDI statistics used by RBI does not conform to the guidelines of the International Monetary Fund (IMF). There are discrepancies like exclusion of reinvested earnings while estimating actual FDI, but according to IMF

[61] Kumar, N. (1998). Liberalisation and Changing Patterns of Foreign Direct Investments: Has India's Relative Attractiveness as a Host of FDI Improved?. *Economic and Political Weekly*, 33(22), 1321-1327.

[62] Majundar, S. K., and Chibber, P. (1998). Are Liberal Foreign Investment Good For India?. *Economic and Political Weekly*, 34(22), 267-270.

[63] Srivastava, S. (2003). What is True Level of FDI Flows to India. *Economic and Political Weekly*, 38(7), 608-610.

guidelines these reinvested earnings are the part of FDI inflows and should be recorded as inflow on the capital account of host country's balance of payments. Secondly, India does not include the proceeds on foreign equity listings and foreign subordinated loans to domestic subsidiaries in FDI while IMF guidelines include them as part of FDI. These discrepancies make FDI data for India uncomparable to those countries which follow IMF Guidelines for the calculation of FDI.

Akhtar (2013)[64] stated in his study on “Inflows of FDI in India: Pre and Post Reform Period” that during pre-liberalization period FDI has increased at compounded annual growth rate of 19.05% and during post liberalization period it has grown to 24.28%. This shows that liberalization has had a positive impact on FDI inflows in India and since 1991 FDI inflows in India has increased approximately by more than 165 times. Nag and Ray (2004)[65] also admitted that FDI inflows into India is the aftermath of economic reforms. This study pointed out the huge amount of FDI inflows failed to contribute to substantial percentage growth of GDP when compared to selected South-East Asian host countries. According to the authors the main reason for the poor contribution of FDI to GDP is mainly because of the concentration FDI in India in the service sector.

Devajit (2012)[66] in his study, “Impact of Foreign Direct Investment on Indian Economy”, besides analysing the impact of foreign direct investment on Indian economy advocates the need of foreign investment in India for her sustained economic growth, creation of employment opportunities, expansion of industries and various other projects related to education, health, research and development etc. Tsai (1994)[67] studied the impact of FDI on GDP, Export and productivity. He studies the major sectors with the help of Panel Co-integration Test. He also points out the concentration of FDI into a few sectors and development of these sectors as a result of FDI. The results also indicate that

[64] Akhtar, G. (2013). Inflows of FDI in India: Pre and Post Reform Period. *International Journal of Humanities and Social Science Invention*, 2(2), 1-11.

[65] Nag, B., and Ray, P. (2004). Experience of Financial Sector Reform in India: A Comparison with Select South East Asian Countries. *Foreign Trade Review*, 38(3), 38-63.

[66] Devajit, M. (2012). Impact of Foreign Direct Investment on Indian Economy. *Research Journal of Management Sciences*, 1(2), 29-31.

[67] Tsai, P.L. (1994). Determinants of Foreign Direct Investment and Its Impact on Economic Growth. *Journal of Economic Development*, 19(1), 137-163.

FDI has a negative relationship with export in three sectors namely transport, chemicals and food processing. The only sector in India that has enjoyed a positive relation between export and FDI is drugs and pharmaceuticals but that may also be due to the multiplicity of Greenfield projects in this sector which have expanded their exports through overseas affiliations by the parent companies. As far as Co-integrating relation between FDI and labour productivity is concerned the study shows that two sectors - transport and metallurgical, have positive relation whereas the other two sectors - food processing and industrial machinery have a negative co-integrating relationship. This means that when there is an increase in the output, export or labour productivity of the sector, it cannot necessarily be attributed to the advent of FDI. One of the important findings of this study is that FDI has failed to make a deep impact on the Indian economy at the sectoral level. It could therefore, be concluded that the advent of FDI has not benefited the Indian economy in a big way at sectoral level.

Resende (2010)[68] pointed out the determining factors of FDI in India. His paper provided an empirical analysis of domestic determinants of FDI such as size of the market, openness to trade, infrastructure, attractiveness to domestic market and exchange rate. In addition, the study includes technology growth as specific variable to examine local determinants of FDI in India. He advocates the expansion of FDI to the agricultural sector, the major component of county's GDP. Hooda (2011)[69] found that foreign direct investment is a vital and significant factor influencing the level of growth in Indian economy. She also estimated the determinants of FDI inflows and found that trade, GDP, research and development, financial position, exchange rate are the important macroeconomic determinants of FDI inflows in India. Singh (2009)[70] highlighted the significant role of FDI in the growth of developing countries like India and the need of FDI friendly policies in such countries. He also studied the trend of FDI since the economic reforms. According to Basu et al. (2007)[71] R& D ac-

[68] Resende Jr. Carlos, (2010). *Determinants of Foreign Direct Investment in an Emerging Market Economy: Evidence from India*, Bryant University.

[69] Sapna, H. (2011). *A Study of FDI and Indian Economy.* PhD Thesis, National institute of Technology, Kurukshetra, Haryana.

[70] Singh, S. (2009). *Foreign Direct Investment and Growth of States of India. Vision 2020 - Managerial Strategies and Challenge*, Wisdom Publications, Delhi.

[71] Basu, P., Nayak, N.C., and Archana, V. (2007). Foreign Direct Investment in India: Emerging Horizon. *Indian Economic Review*, 42(2), 255-266.

tivity is a significant determining factor for FDI in most of the industries in India. According to him the FDI attraction of software industry is because of intensive R& D activity there. In their opinion corporate tax adversely affects FDI flows.

Agrawal et al. (2011)[72] made a comparative study of the role of FDI in the economic growth of China and India during 1993-2009 using a Modified Growth Model and investigated the effect of FDI on economic growth of China and India. The factors included in the Growth Model were GDP, human capital, labour force, FDI and gross capital formation. On the basis of OLS Method of Regression they found that China's growth is more affected by FDI than India's growth. The majority of the foreign investors prefer China to India for investment because China has a bigger market size than India, better government incentives, developed infrastructure, cost - effectiveness, easy accessibility to export market and favourable macro-economic climate. Iqbal et al. (2013)[73] also studied the impact of FDI on the economic growth of India and China. They compared India and China in attracting FDI and benefiting out of FDI. According to them with regards to the growth of both countries FDI plays a positive role i.e., FDI contributed to the GDP growth and increase of the per capita income of both India and China. However China attracts more FDI than India thanks to her infrastructure facility, business environment etc.

A similar study was made by Gwartney (2010)[74] comparing the role of FDI in the economic growth of Bangladesh, India, Pakistan and Sri Lanka. He used Simple Log Linear Regression Model. He found that FDI along with exports played statistically significant role in the economic growth of these countries and hence he advocated that they should encourage exports and FDI to accelerate their further economic growth. Anitha (2012)[75] projected of FDI inflows into India from 2010-15 using Autoregressive Integrated Moving Average (ARIMA) forecasting techniques. She also identified the factors which prevent

[72]Agrawal, G., and Khan, M. A. (2011). Impact of FDI on GDP: A Comparative Study of China and India. *International Journal of Business and Management*, 6(10), 71-79.

[73]Zafar, L., Imran, M., and Ramzan, M. (2013). Foreign Direct Investment and Economic Growth: Comparative Position of Chinese and Indian Economies. *Journal of Business Studies*, 4(3), 52-61.

[74]Gwartney, J. (2010). Institutions, Economic Freedom, and Cross-Country Differences in Performance. *Southern Economic Journal*, 75(4), 937-956.

[75]Anitha, R. (2012). Foreign Direct Investment and Economic Growth in India. *International Journal of Marketing, Financial Services and Management Research*, 1(8), 108-125.

FDI and suggested innovative policies and good corporate governance to attract more FDI to India. Gaurav (2010)[76] found out in his study that foreign direct investment has a major role to play in the economic development of the host countries including India. He observed that most of the countries have been using foreign investment and foreign technology to accelerate the pace of their economic growth. According to him since FDI ensures a huge amount of non-debt capital, production level and employment opportunities in the developing countries, it is a major step towards the economic growth of India.

There are also several writers who strongly criticise FDI in general and FDI in India in particular. Bevan et al. (2004)[77] studying the relationship between FDI and economic growth of Turkey argues that FDI has no role in the economic growth of Turkey in the short run or long run. From his study based on the impact of FDI on the economic growth of Pakistan, Falki (2009)[78] observed a downward trend of FDI during the economic growth of Pakistan from 1980-2006 and concluded that FDI has no significant role in the economic growth of Pakistan during that period. Another large scale study selecting 72 countries by Carcovic and Levin (2000)[79] using Ordinary Least Square method also did not see considerable FDI influence in the economic growth of these countries they selected for the study. But it must be remembered that the period selected for the study was 1960-1995 when FDI was in its infant stage. FDI became full-fledged only since globalization.

Again in his study on the effect of FDI on the economic growth of Malaysia using GARCH and Causality Approach Duasa (2007)[80] also did not see any causal relationship between the economic growth of Malaysia and the FDI flow to there and hence conclude that there is no causal relationship between economic growth and FDI. Kim and Seo (2003)[81] have a similar finding in their

[76] Gaurav, A. (2011). Impact of FDI on GDP: A Comparative Study of China and India. *International Journal of Business and Management*, 6(10), 132-140.

[77] Bevan, A., Estrin, S., and Meyer, K. (2004). Foreign Investment Location and Institutional Development in Transition Economies. *International Business Review*, 13(1), 43-64.

[78] Falki, N. (2009). Impact of Foreign Direct Investment on Economic Growth in Pakistan. *International Review of Business Research Papers*, 5(5), 110-120.

[79] Carkovic, M., and Levine, R. (2000). *Does Foreign Direct Investment Accelerate Economic Growth?*. University of Minnesota, Working Paper.

[80] Duasa, J. (2007). Malaysian Foreign Direct Investment and Growth: Does Stability Matters. *Journal of Economic Co-operation*, 28 (2), 83-98.

[81] Kim, D.D., and Seo, J.S. (2003). Does FDI Inflow Crowd Out Domestic Investment in Korea. *Journal of Economic Studies,* 30 (6), 605-22.

study using Vector Auto Regression Models on the role of FDI on the economic growth and domestic investment in Korea for the period of 1959-1999. According to them though FDI has some impact on the economic growth of Korea it is insignificant. The also found that FDI made no significant role to boost the domestic investment in Korea.

There are also writers like Mathiyazhagan (2005)[82] who see no considerable impact of FDI on the economic growth of India. He argues that at the sectoral level of the Indian economy FDI failed to produce positive impact. Instead of FDI he suggests the opening of export oriented sectors for achieving higher growth of the economy through the growth of these sectors. Chakraborty and Nunnenkamp (2006)[83] also pointed out similar defect of FDI in India i.e., neglect of primary sector and over emphasise of manufacturing sector. They also pointed out despite the concentration of FDI on the service sector, it fail to produce proportionate result in this sector. They advocate further relaxations and opening of more industries to the FDI. According to Ahmad and Hamdani (2003)[84] in the economic growth of Pakistan, the role of domestic private investment is more significant than FDI. In their opinion the repatriation of FDI profit will adversely affect the economic growth of the host economies. Nonnemberg et al. (2004)[85] refute the argument that there is two way relationship between FDI and economic growth. According to them though economic growth attracts more FDI, FDI does not contribute to the economic growth.

[82]Mathiyazhagan, K.M. (2005). *Impact of Foreign Direct Investment on Indian Economy: A Sectoral Level Analysis*. ISAS Working Paper, Institute of South Asian Studies Singapore.

[83]Chakraborty, C. and Nunnenkamp, P., (2008). Economic Reforms. FDI and Economic Growth in India: A Sector Level Analysis. *World Development*, 36(7), 1192-1212.

[84]Ahmad, E., and Hamdani, A. (2003).T he Role of Foreign Direct Investment in Economic Growth. *Pakistan Economic and Social Review*, XLI (1 & 2), 29-43.

[85]Nonnenberg, M., and Mendonca, M. (2004). The Determinants of Direct Foreign Investment in Developing Countries. Proceedings of the 32th Brazilian Economics Meeting, Brazil.

2.2 Studies Related to Foreign Portfolio Investment (FPI)

Foreign investment in the capital market i.e., foreign portfolio investment, also received equal attention from the academic world. There are several studies about foreign portfolio investment especially by the foreign institutional investors and majority of them are conducted internationally. According to Bekaert and Harvey (1998)[86] stock market performance of the host country or economy itself is a crucial factor in attracting FPI and build their confidence to invest further in stock market. Levine (1997)[87] points out that high stock market return attract foreign investors. Another study by Agbloyor, et al. (2013)[88] gives an interesting observation i.e., development in the banking sector causes foreign investment and foreign investment brings development in the banking system. Industrial production is considered as an important factor influencing the foreign portfolio investment by Chuhan, et al. (1993)[89]. According to them foreign capital flows were less volatile in developed countries where industrial production growth rate was rather stable than emerging countries. Vita and Kyaw (2008)[90] found that output and industrial production as pull factors were the most important forces to explain the volatility in foreign investment flows. Therefore, they conclude that the increase of the industrial production of the host country will increase the foreign investment in that country.

Froot, et al. (2002)[91] explored the interaction between exchange rate and foreign institutional investment flows. Using VAR Analysis and Variance De-

[86]Bekaert, G., Harvey, C.R. (1998). *Capital Flows and the Behaviour of Emerging Market Equity Return.* Working Paper 6669, National Bureau of Economic Research, Cambridge.

[87]Levine, R. (1997). Financial Development and Economic Growth: Views and Agenda. *Journal of Economic Literature*, 35(2), 688-726.

[88]Agbloyor, E. K., Abor, J., Adjasi, C. K., and Yawson, A. (2013). Exploring the Causality Links between Financial Markets and Foreign Direct Investment in Africa. *Research in International Business and Finance*, 28(C), 118-134.

[89]Chuhan, P., Claessens, S., and Mamingi, N. (1993). *Equity and Bond Flows to Asia and Latin America. Policy Research.* Working Papers No. 1160, The World Bank, Washington, DC.

[90]Vita, G.D., and Kyaw, K.S. (2008). Determinants of FDI and Portfolio Flows to Developing Countries: A Panel Co-integration Analysis. European Journal of Economics, *Finance and Administrative Sciences*, 13(4), 124-132.

[91]Froot,. K., and Ramadorai, T. (2002). *Currency Returns, Institutional Investor Flows and Exchange Rate Fundamentals.* NBER Working Paper Series 9080, National Bureau of Economic Research, Cambridge (MA).

composition, they found that foreign institutional flows were highly correlated with exchange rate. Jenkins and Thomas (2002)[92] examined the determinants of foreign portfolio investment (FPI) in six developing Asian countries. Their study using Regression Analysis show that inflation rate, index of economic activity, the share of domestic capital market in the world and stock market capitalization are four statistically significant determinants of FPI. According to the study result except inflation all the other three variables are positive determining factors of FPI and inflation is a negative determinant. Scholars like Rai and Bhanumurthy (2004)[93] found negative effect of domestic inflation on FPI and concluded that inflation in home country and higher returns in host country induce foreign investors to move into the host country. Agarwal (1997)[94] also found negative relation between inflation rate and exchange rate with foreign portfolio investment.

Brink and Viviers (2003)[95] studied the obstacles in attracting investments into Southern Africa. The study identified the underdevelopment of financial market as the major obstacle in attracting FPI. Other obstacles identified were: macro-economic instability, high interest rate, exchange rate risk, high tax structures, and inadequate availability of information and under developed telecom infrastructure. Dahlquist and Robertsson (2002)[96] studied the investment behaviour of foreign investors in association with equity market liberalization in the Swedish equity market and found a strong link between foreign portfolio investment and local market returns. They noticed that in the period following the liberalization, foreigner's net purchases led to a permanent increase in prices, or equivalently, a permanent reduction of the cost of equity capital. Stulz (1999)[97] showed that globalization allows better foreign investors to participate in the market and improve corporate governance, thereby allow-

[92] Jenkins, C., and Thomas, L. (2002). *Foreign Direct Investment in South Africa: Determinants, Characteristics and Implications for Economic Growth and Poverty Alleviation.* Centre for the Study of African Economics, University of Oxford, London.

[93] Rai, K., and Bhanumurthy, N. R. (2004). Determinants of Foreign Institutional Investment in India. The Role of Return, Risk and Inflation. *The Developing Economics*, 42(4), 479-493.

[94] Agarwal, R. (1997). Foreign Portfolio Investment in Some Developing Countries: A Study of Determinants and Macroeconomic Impact. *Indian Economic Review*, 32(2), 217-229.

[95] Brink, N., and Viviers, W. (2003). Obstacles in Attracting Increased Portfolio Investment into Southern Africa. *Development Southern Africa*, 20(2), 213-236.

[96] Dahlquist, M.,and Robertsson, G. (2001). Direct Foreign Ownership, Institutional Investors and Firm Characteristics. *Journal of Financial Economics*, 59(3), 413-440.

[97] Stulz, R. M. (1999). *International Portfolio Flows and Security Markets.* NBER Conference Report Series, University of Chicago Press, Chicago and London.

ing for an improved relationship between the foreign investors and corporate managers. Wang (2004)[98] noticed a significant relationship between foreign portfolio investment and market volatility in Indonesia and Thailand. Outflow of foreign portfolio investment was the most significant causes of market volatility. He reported that contrary to the expected outflows of portfolio investments during the Asian crisis, foreign investors were net buyers in both markets, and that foreign investors appeared to be leading in the price adjustment process in Indonesia.

If the above studies are mainly concentrated on the determinants and impact of FPI in general, there are some other studies which deal with the impact of FPI on the macro economic variables in India. Goldstein et al. (1991)[99] suggested that the right to repatriate dividends and capital might be the most important factor in attracting significant foreign equity flows. According to him countries that allow foreign investors to repatriate capital and income freely and without restriction attract more FPI than countries which impose some restrictions on the repatriation of capital and income.

Williamson (1993)[100] pointed out that when developing countries creditworthiness is restored, capital (bond and equity) flows are likely to become an increasingly prominent source of external finance. According to him although portfolio equity flows to developing countries have increased sharply in recent years, they are expected to be extremely sensitive to a country's openness, particularly to rules concerning the repatriation of capital and income. Sau (1994)[101] presented a simple model to examine the conditions of stability with the inflow of foreign capital. He found that the equilibrium is most likely to be stable if the interest elasticity of direct foreign investment is high and that of foreign portfolio investment is low. But the experience of India is just the reverse, i.e., the possibility of instability. The instability may take the form of appreciation of the rupee accompanied by falling income. He also observed that

[98] Wang, J. (2007). Foreign Equity Trading and Emerging Market Volatility: Evidence from Indonesia and Thailand. *Journal of Development Economics*, 84(2), 798-811.

[99] Goldstein, M., Mathieson, D., and Timothy, L. (1991). *Determinants and Systematic Consequences of International Capital Flows in IMF Research Department.* Occasional Paper 77, Washington DC, IMF.

[100] Williamson (1993). *Issues Posed by Portfolio Investment in Developing Countries.* Discussion Paper 228, Washington DC, World Bank.

[101] Sau, R. (1994). Foreign Direct Investment, Foreign Portfolio Investment and Macroeconomic Stability. *Economic and Political Weekly.* XXIX(7), 386-390.

with the recent liberalization in India, the stock markets are receiving foreign portfolio investment at the rate of some four million dollars per day and FPI in India is attracted by higher interest rate in primary and secondary market of debt market which in turn facilitates appreciation of the currency of the country.

Rao et al. (1999)[102] studied the trends in foreign institutional investment in the Indian stock market. The study begins by drawing attention to the changes in the nature and magnitude of capital flows to developing economies in recent times after briefly examining the favourable and unfavourable impact of FPI on domestic economy, the authors analysed the importance of different types of foreign portfolio investment. The study also examined the countrywide distribution of FIIs registered with the SEBI and the share of different categories of companies in the market value of investments. The study also examined the exposure of five India- specific US funds drawing attention to the changing sectoral importance during the period 1996-98. Based on their study the authors conclude that FII investment considerably influence stock prices in India.

Mohan (2006)[103] also examined the trends in foreign institutional investment in emerging markets in general and India in particular. According to him in mature economies institutional investors have replaced banks as the primary custodian of the savings of the people. These institutional investors are mutual funds, insurance firms, pension funds and hedge funds who command huge resources are diversifying their portfolios through investments in debt and equity in emerging markets. Huge capital flows into emerging markets via foreign institutional investors have substantially augmented the foreign exchange reserves of those economies besides boosting their stock markets. He dispels the fears that FII investment can be destabilizing. In India FII investment has been steady and positive with modest volatility so far. According to him, the real problem caused by variations in FII inflows is not stock market volatility but the difficulties posed in the management of money supply and exchange rate. Rai and Bhanumurthy (2004)[104] examined the determinants of foreign institu-

[102]Rao, Chalpati, K.S., Murthy, M.R., and Ranganathan, K.V.R. (1999). Foreign Institutional Investment and the Indian Stock Market. *Journal of the Indian School of Political Economy*, 9(4), 423-454.

[103]Mohan, T. (2006). Neither Dread Nor Encourage Them. *Economic and Political Weekly*, 3(4), 95-98.

[104]Rai, K., and Bhanumurthy, N.R (2004). Determinants of Foreign Institutional Investment in India: The Role of Return, Risk, and Inflation. *The Developing Economies*, 42(4), 479-493.

tional investment in India. By using monthly data, they found that FIIs inflow depends on stock market returns, inflation rates (both domestic and foreign), and exchange rate risk. In terms of magnitude, the impact of stock market returns and the exchange rate risk turned out to be the major determinants of FII inflow. According to them stabilizing stock market volatility and minimizing the exchange rate risk would help to attract more foreign institutional investment which has a positive impact on the real economy.

Jain et al. (2011)[105] found that FIIs flows to India have steadily grown in importance. According to them all the economies of the world are affected by foreign investment and movement of their capital market is an indicator of the performance of their companies in a particular industry. This paper also attempts to understand the behavioural pattern of FIIs in India. Anand Bansal and Pasricha (2009)[106] using stock market data related to Bombay Stock Exchange, for both before and after the FIIs policy announcement day examined the impact of market opening to FIIs on Indian stock market behaviour. An empirical examination has been conducted to assess the impact of the market opening on the returns and volatility of stock return. They found that there is significant changes in the Indian stock market returns, and volatility.

Sunil and Chandra (2007)[107] examined the influence of foreign institutional investment in explaining the short and long run relationship of the Indian equity market with the main developed equity markets of the US and the UK and concluded that the rapid growth in the flow of the foreign portfolio investment is leading to greater integration of the Indian equity market with the main developed markets and this may have significant implications for asset pricing and international portfolio diversification benefits.

Manjinder and Sharanjit (2010)[108] explored the determinants of foreign in-

[105]Jain, M., Meena, P. L., and Mathur, T. N. (2012). Impact of Foreign Institutional Investment on Stock Market with Special Reference to BSE: A Study of Last One Decade. *Asian Journal of Research in Banking and Finance*, 2 (4), 31-47.

[106]Bansal, A., and Pasricha, J.S. (2009) . Foreign Institutional Investor's Impact on Stock Prices in India. *Journal of Academic Research in Economics*, 1(2), 255-270.

[107]Poshakwale, S., and Chandra, T. (2007). *Impact of Foreign Portfolio Investments on Equity Market Co-movements: Evidence from the Emerging Indian Stock Market.* Emerging Market Group ESRC Seminar on International Equity Markets Co-movements and Contagion, Cass Business School, London.

[108]Kaur, M., and Dhillon, S. S. (2010). Determinants of Foreign Institutional Investor's Investment in India. *Eurasian Journal of Business and Economics*, 3 (6), 57-70.

stitutional investment in India. According to them returns on Indian stock market have positive impact whereas US stock market returns have no significant influence on FIIs investment in India. But stock market risk has however a negative influence on FIIs inflows to India. Market capitalization and stock market turnover of India have significant positive influence only in the short-run. Among macroeconomic determinants, economic growth of India has positive impact on FIIs investment both in long-run and short run. But all other macroeconomic factors have significant influence only in long-run. Inflation in US has positive influence whereas inflation in India has negative influence on FIIs investment in India. Further, hike in the US interest rate has adverse impact on FIIs investment while liberalization policies of India exhibited significant contribution to FIIs inflows. Thus according to them FPI in India are determined by both stock market characteristics and macroeconomic variables of Indian economy.

Patil (2007)[109] examined the current state of the Indian capital market tracing its evolution and growth in the reform era starting in early nineties. He draws attention to the fact that before reforms Indian capital market was really backward in most respects. After the initiation of capital market reforms as part of the economic reforms in the country, the Indian capital market was completely transformed and today it ranks among the best markets. According to Patil this transformation was made possible by reforms such as setting up of the NSE, SEBI, Depositories, Online Trading, Rolling Settlement and the opening up of the market to FIIs.

Rathod (2007)[110] studied the role of Private Equity (PE) Funds in the Indian stock market. According to Rathod developed, mature markets are increasingly getting saturated with low GDP growth and mediocre stock market returns. On the other hand, growth rates have shot up in developing markets like China and India and the consequent high levels of corporate profitability and its apparent sustainability for long periods of time are attracting private equity funds on a massive scale to emerging markets. This seems to be a new trend in global financial markets. Rathod distinguishes between different forms

[109]Patil, R.H. (2006). Current State of the Indian Capital Market. *Economic and Political Weekly*, 41(11), l001-1011.

[110]Rathod, G.D. (2007). Private Equity: Creating Wealth for India Incorporated. *Portfolio Organiser*, 4(3), 14-23.

of investors such as FIIs, PE Funds and Hedge Funds. FIIs usually invest in listed companies. But PE Funds mainly invest in unlisted companies and they invest through a negotiated process since the price of the stock is unknown in the absence of stock market listing.

Chandrasekher (2007)[111] traces the growth of PE Funds in India in recent times. He draws attention to the increasing role of PE Funds in M& A deals struck in India and their probable negative impact on emerging economies via acquisition of domestic companies by foreign companies using the PE route. As and when FDI norms are relaxed, PE Funds can sell the stocks they own to foreign companies or takeover specialists through block deals. This will weaken the domestic corporate sector. Chandrasekher traces the emergence and growth of PE Funds globally. Chandrasekher focuses on the areas of concern arising from PE investment. According to him the very nature of the business organization is not transparent unlike registered FIIs. Chandrasekher's study, warns the possibility of the takeover of domestic companies by foreign companies.

The writers who studied the post reform capital market in India observed that repatriate dividends and capital, credit worthiness of host countries, domestic and foreign inflation rate, economic growth, etc. are the major factors which attracted FPI to India. All of them recognised the huge capital flows into India after the granting of FPI. Prasuna (2000)[112] studied the determinants of FIIs investment in India using monthly data from 1993 to 1998 and found that there is significant relation between FIIs investment and BSE returns whereas exchange rate, interest rate, forward premium and foreign exchange reserves have only insignificant relation to FIIs investment. Similarly Saraogi (2008)[113] investigated the determinants of FIIs flows into India using monthly data from 2001 to 2007 and found BSE market returns has positive impact on FIIs. Besides, according to the study the impact of inflation and exchange rate on FIIs flows into India is negative. Kaur and Dhillon (2010)[114] also put forward a similar view. According to their study based on monthly data from 1995 to 2006,

[111]Chandrasekher, C.P. (2007). Private Equity: A New Role for Finance?. *Economic and Political Weekly*, 42(13), 1136-1145.

[112]Prasuna, C. A. (2000). Determinants of Foreign Institutional Investment in India. *Finance India*, 14(2), 411-421.

[113]Saraogi, R. (2008). *Determinants of FIIs Inflows: India.* MPRA Working Paper No.22850.

[114]Kaur, M., and Dhillon, S. (2010). Determinants of Foreign Institutional Investors Investment in India. *Eurasian Journal of Business and Economics*, 3(6), 57-70.

Indian stock market return has positive impact on FIIs flow in India. But they argue that inflation has negative influence on FIIs flows into India.

Other writers like Kumar and Gupta (2010)[115], also agreed with this view. According to them stock return and exchange rate are the major determinants of FIIs flows into India. But there is a bi- directional causality between the returns of the Indian stock market and the foreign investment flows. Bhasin and Khandelwal (2013)[116] identified the determinants of FIIs inflows in India, with special reference to the impact of crisis, using monthly data from April 1994 to December 2011. They found that the factors affecting FIIs inflows to India are market index return, and the growth rate of the economy etc. They also found the global financial crisis of the year 2008 had a significant impact on net FII inflows. Srinivasan and Kalaivani (2013)[117] explored the determinants of foreign institutional investments in India through ARDL Bounds Testing Approach and showed that exchange rate has significant negative impact on FIIs inflows both in the short-run and long-run, implying that depreciation of currency adversely affects the FII flows into India.

Garg and Bodla (2009)[118] examined the determinants of FIIs in Indian stock market and found that the market return is the prime mover of the net FII inflows into India. Nidhi Dhamija (2008)[119] made an exploratory analysis of the investment of FIIs patterns across firms to examine the role of various factors relating to individual firm level characteristics and macro level conditions influencing FII. It was found that the regulatory environment of the host country plays a major role impacting the FIIs. Tripati and Rudra (2007)[120] added good monetary policies and stabilize foreign exchange market to the determinants of FII inflow into India. Mishra (2010)[121] also found that reciprocal relationship

[115] Kumar, R., and Gupta, H. (2010). FIIs Flows to India: Economic Indicators. *SCMS Journal of Indian Management*, 7(1), 104-116.

[116] Bhasin, N., and Khandelwal, V. (2013). Foreign Institutional Investment in India: Determinants and Impact of Crises. *The Indian Journal of Commerce*, 66(2), 1-15.

[117] Srinivasan, P., and Kalaivani, M. (2013). *Determinants of Foreign Institutional Investment in India: An Empirical Analysis.* MPRA Working Paper No. 43778, University Library of Munich, Germany.

[118] Garg, A., and Bodla, B.S., (2009). Determinants of FIIs Investment in Indian Stock Market. *Abhigyan*, 26(4), 12-24.

[119] Dhamija, N. (2008). Foreign Institutional Investment in India - An Exploratory Analysis of Pattern Across Firms. *Margin-Journal of Applied Economic Research*, 2(3), 287-320.

[120] Tripati, R.D., and Rudra, S. (2007). Interest Rate Signals, Stock Returns and FII Inflows: Exploring the Inter Linkages, Metamorphosis. *Journal of Management Research*, 6(1), 54-68.

[121] Mishra, P.K. (2010). The Estimation of Relationship between Foreign Investment Flows and Economic

between FII and economic growth in India in his study in the period 1993-2009.

Amita (2014)[122] identified the determinants of foreign institutional investment and established a relationship between them using exchange rates, BSE Sensex, foreign exchange reserves and inflation as variables. She used secondary data obtained on monthly basis collected from 2001-02 to 2012-13. Econometric tools, Augmented Dicker Fuller Test and Granger Causality Test are used to analyse the data. The correlation coefficient between FIIs and Sensex, FIIs and FERs, FERs and Sensex, and WPI and Sensex were found positive. However, exchange rate and inflation showed negative relationship with FIIs. The results of Granger Causality Model indicated bi-directional causality between FII and Sensex, and FII and exchange rate. However, no causality was found between FII and foreign exchange reserves.

Basu and Morey (1998)[123] analysed the impact of economic reforms (since 1984) on stock market return in India. They employed the Non-parametric Variance Ratio Tests spanning over the period 1957 to 1996. The study showed that from mid 1980s, equity prices in India behaved like a 'random walk' suggesting that the market obeyed Fama's Efficient Market Hypotheses, till the securities scam of 1991- 92.

There are some scholars who paid attention to the impact of FPI on the Indian economy. For example (Sethi 2012)[124] using the Vector Auto Regression (VAR) method, examined the effects of foreign capital inflows on the macroeconomic variables such as exchange rate, inflation, money supply, foreign exchange reserve, etc. in India with the help of monthly data from 1995 to 2011. The results showed that there is a dynamic short and long equilibrium relationship between macroeconomic variables like exchange rate, foreign exchange reserve, and money supply with foreign capital inflows. But no significant relation between foreign investment and inflation is found. Ghosh and Herwadkar (2009)[125] found that there exist a long term relation between foreign capital

Growth in India. *Asian Economic Review*, 52(3). 521-531.

[122]Amita (2014). Determinants of FIIs: Evidence from India. *International Journal of IT and Knowledge Management*, 8(1), 85-95.

[123]Basu, P., and Morey, R.M. (1998). Stock Market Prices in India After Economic Liberalization. *Economic and Political Weekly*, 4(3), 355-358.

[124]Sethi, N. (2012). Inflows and Their Macroeconomic Impact in India a VAR Analysis. *The Romanian Economic Journal*, 15(46), 93-142.

[125]Ghosh, S., and Herwadkar, S. (2009). *Foreign Portfolio Flows and Their Impact on Financial Markets*

flows and exchange rate appreciation. In the short run, the VAR and Impulse Response Functions also indicated that a positive shock to net FII flows generally result in exchange rate appreciation.

Babu and Prabheesh (2008)[126] argued in their study using like VAR, Impulse Response and Granger Causality Test to study the relationship between FIIs flows and stock market return in India and found that there is a reciprocal relationship between the FIIs flows and stock market return in India. i.e., Changes in Nifty caused changes in FII flows and changes in FIIs flows cause changes in Nifty. However impact of stock return on FIIs flows is higher than the impact of FIIs on the stock return. The Impulse Response Function (IRF) showed that the flows of FII in the Indian economy were more driven by the Indian stock market returns. Gordon and Gupta, (2003)[127] confirmed causal effect from FII inflows to return in BSE. They observed that FIIs act as market makers and book profits by investing when prices are low and selling when they are high. Therefore, there is a need to investigate whether FIIs are the cause or effect of stock market fluctuations in India. Pal (2004)[128] found that FIIs are the major players in the Indian stock market and their impact on the domestic market is increasing. Trading activities of FIIs and the domestic stock market turnover indicate that FIIs are becoming more important and increasingly higher share of stock market turnover is accounted by FIIs trading in India.

The above discussion made so far does not mean that all the writers are holding a positive view about FPI. There are several writers who strongly criticise FPI in general and FPI in India in particular. Singh (1998)[129] examined the growth and evolution of stock markets in India during 1990s which according to him is largely due to internal and external liberalization measures and the general liberal economic ethos created by the reforms. He argued that even

in India. Reserve Bank of India Occasional Papers, 30(3), 2-22.

[126] Babu, S., and Prabheesh, K.P. (2008). Causal Relationship between FIIs and Stock Returns in India. *International Journal of Trade and Global Market*, 1(3), 259-265.

[127] Gordon, J., and Gupta, P. (2003). *Portfolio Flows into India: Do Domestic Fundamentals Matter?*. IMF Working Paper, Number WP/03/20.IMF, Washington, DC.

[128] Pal, P. (2004). Foreign Institutional Investment in India. Research on Indian Stock Volatility, Vol.12, Emerald Group Publishing Limited.

[129] Singh, A. (1998). Liberalization, the Stock Market and The Market for Corporate Control; A Bridge too far for the Indian Economy. In I.J Ahluwalia and I.M.D Little (eds), India's Economic Reforms and Development. *Oxford University Press*, 1691-99.

though the corporate sector considerably benefited from the boom in the stock market by raising huge amounts of capital including foreign exchange, from the market, the aggregate real economy did not benefit from this. He did not see any increased productive use of investment resources. His conclusion is that despite all the extraordinary growth achieved by the stock market, as far as the real economy was concerned, it has just been a sideshow. He also sounded a note of warning that with the development of corporate control as a result of mergers, takeovers, acquisitions and divestments, the situation will worsen and the real economy will be harmed by these developments.

A comprehensive empirical work came from Nagaraj (1996)[130]. He examined the long-term trends in India's capital markets and the structural changes that have taken place in the country's saving pattern. Examining important indicators like the amount of capital raised, share of equity in total capital mobilized, share of financial saving in Gross Domestic Savings, Gross Fixed Capital Formation, Corporate Profitability etc. he came to the following conclusions: In India, the growth of the capital market was in fact was portfolio substitution by households and institutions from bank deposits to stock market instruments. There is no correlation between growth rate of capital mobilization, aggregate saving rate and corporate physical investment. The positive correlation between the annual growth rate of capital rose externally and the corporate fixed capital formation, which existed previously, was statistically insignificant in the 1980s. There is a long-term decline in the contribution of internal finance to corporate fixed investment, despite a fall in the ratio of corporate tax to gross profit. The growth rate of real value added in the corporate manufacturing sector in the 1980s was lower than that of registered manufacturing sector as a whole suggesting that the small corporate firms, which did not have access to stock market funds, were able to grow at a faster rate than the larger corporate firms.

Another prominent critic of hasty financial liberalization and foreign portfolio investment is Stiglitz (1998)[131]. Citing the example of South East Asian countries during the South East Asian currency crisis of 1997-98, he argued

[130] Nagraj, R. (1996). India's Capital Market Growth, Trends, Explanations and Evidence. *Economic and Political Weekly*, 31(35), 2553-61.

[131] Stiglitz, J.E. (1998). The Role of International Financial Institutions in the Current Global Economy. The Rebel Within London, Wimbledon Publishing Company, 172-193.

that developing countries are far more vulnerable to volatility in capital flows and it will ruin the financial and real sectors of the economy. Therefore he advocated greater control and regulation of capital flows into the developing countries. Durham (2004)[132] studied the effects of FDI and Equity Foreign Portfolio Investments (EFPI) on economic growth using data on 80 countries for the period 1979-1998. He constructed six capital absorptive variables and framed regression equations. The complete cross sectional analysis covered data on 62 non-OECD (Organization of Economic Co-operation and Development) and 21 high income countries. The study found that the effects of FDI and EFPI on growth depend on the absorptive capacity of host countries and this in turn depends on the institutional and financial absorptive variables.

Thus his important conclusion is that the effects of FDI and EFPI depend on the 'absorptive capacity' of host countries. His analysis also showed that FDI and EFPI have no unmitigated positive effect on economic growth. Therefore, he suggested that leaving financial markets alone is not a good way to encourage them and unfettered capital flows do not necessarily enhance growth.

Rishit (2007)[133] presented a critique of the approach and recommendations of the 2004 Government of India Expert Group on Foreign Institutional Flows. The Expert Group was set up to 'suggest measures for encouraging foreign institutional flows'. While recognizing the fact that FII flows have strengthened India's balance of payments position, he cautions against unbridled encouragement of highly volatile and potentially destabilizing FII flows as there is no empirical evidence proving the beneficial impact of such flows on economic growth. He also questioned the government's policy assumption that FII flows are always investment and growth promoting.

Soros (2004)[134], because of the influences of East Asian Currency Crisis, argues for intervention of international financial authorities to rescue the global capitalist system from its grave crisis. According to him the global economy characterized by free trade in goods and services and free movement of capital

[132] Durham, J.B. (2004). Absorptive Capacity and the Effects of FDI and EFPI on Economic Growth. *European Economic Review*, 48(2), 285-306.

[133] Rishit, M. (2007). On Liberalizing Foreign Institutional Investment. *Economic and Political Weekly*, XLI(11) 991-1000.

[134] Soros, G. (2004). The Crisis of Global Capitalism [Open Society Endangered] Viva Books, New Delhi.

across national boundaries have led to a situation where interest rates, exchange rate and stock prices in various countries are intimately interrelated, and global financial markets exert tremendous influence on economic conditions. Market volatility and currency crisis of the last two decades have produced far reaching economic and political consequences. Mayer (1989)[135] also put forward very strong theoretical disagreements with the World Bank's views on stock market development and economic growth. Based on his studies using corporate balance sheets Mayer observed that in no country do companies raise substantial amount of finance from the securities market and banks are the main sources of external finance in all countries.

Sula and Willet (2006)[136] are also prominent critics of FPI. According to them despite its numerous virtues, FPI could have adverse effects on the host economy. Similarly Kunt and Detragiache (1999)[137] made a case study of countries which experienced financial crisis and came to the conclusion that the volatility of foreign portfolio investment makes stock market volatile and this volatility leads to financial crisis. Patro and Wald (2005)[138] explained a little more and examined how FPI adversely affect the host economy. According to him FPI instability complicates the implementation of macroeconomic stabilisation policies by the policymakers. Uncertainties in the flow of FPI result in unpredictable behaviour of money supply, exchange rate level and stock market volatility. Bank Negara Malaysia (2006)[139] viewed the situation in a different way. i.e., he argued that sustained periods of excessive capital inflows due to high capital mobility could result in the formation of asset price bubbles, leading to inflationary pressure, while sudden withdrawals in portfolio investment accompanied by major correction in asset prices can pose serious risk to the economy. Duasa and Kassim (2009)[140] examined foreign portfolio investment

[135]Mayer. (1989). *Myths of the West: Lessons from Developed Countries for Development Finance.* W.P.S 301, The World Bank, Washington, D.C.

[136]Sula, O., and Willett, T.D. (2006). *Reversibility of Different Types of Capital Flows to Emerging Markets.* MPRA Paper 384, University Library of Munich, Germany.

[137]Demirguc-Kunt, Asli, and E. Detragiache (1999). *Financial Liberalisation and Financial Fragility.* Proceedings of the World Bank Annual Conference on Development Economics, W.P. No 1917, The World Bank.

[138]Patro, D., and Wald, P. (2005). Firm Characteristics and the Impact of Emerging Market Liberalisation. *Journal of Banking and Finance*, 29(7), 1671-1695.

[139]Bank Negara Malaysia (2006). Financial Stability and Payment Systems Report. Kuala Lumpur.

[140]Duasa, J., and Kassim, S.H. (2009). Foreign Portfolio Investment and Economic Growth in Malaysia. *The Pakistan Development Review*, 48(2), 109-123.

and economic growth in Malaysia. They followed Granger Causality Test and Toda and Yammamoto's Non Causality test for their study of the impact of FPI on the economic growth of Malaysia. According to them whenever the Malaysian economy witnessed weakness there was lower FPI inflow to Malaysia and massive FPI outflow from there.

2.3 Research Gap

The review of literature made so far shows that the current interest in foreign investment, especially since globalization, is also reflected in the literature related to foreign investment. Yet despite the large volumes of works, the literature on foreign investment in India is comparatively very few i.e., it is disproportionate with the quantity of foreign investment in India. This calls for more research in this area.

Similarly as observed earlier comprehensive studies about foreign investment are very scarce. Majority of them are in the form of research papers focusing either one of the two aspects of foreign investment viz FDI or FPI by means of commonly used statistical tests like Ordinary Least Square Method, Granger Causality Test etc. Since neither FDI nor FPI is a true representation of foreign investment in India, such exclusive studies on FDI or FPI cannot give a comprehensive view of foreign investment in India. For example it may be fallacious if one comes to the conclusion that foreign investment has a positive impact on Indian economy solely on the basis of an exclusive study of FDI or foreign investment has negative impact on the Indian economy on the basis of another exclusive study on FPI. Because both FDI and FPI belong to different categories in the sense that the former is comparatively a permanent form of foreign investment whereas the latter is comparatively a volatile form of foreign investment.

Again, studies which appear either one of the above broad category further specialise only certain aspects of FDI or FPI; like the determinants of FDI or FPI or their impact on particular macroeconomic variables like economic growth, inflation, exchange rate etc. In this sense existing literature on foreign investment are micro in nature as they emphasize only one or two economic

variables. Further with regards to the impact of foreign investment on these variables, or the role of these variables in attracting FDI or FPI, there is no consensus among writers. For example when some scholars argue that there is a positive relationship between FDI and economic growth, some others find that it is negative. Same is the case with the determinants of foreign investment too. When some find great role for economic reforms in attracting foreign investment others attribute major role for the macroeconomic variables.

similarly since each economic variable is unique in itself simply by studying a particular variable it is not possible to arrive at generalization about the impact of foreign investment on Indian economy. For instance by finding out that foreign investment is conducive for economic growth in India, one cannot generalize that foreign investment is favourable for Indian economy as a whole. Same is the case with the other variables like inflation where, foreign investment may have a negative impact on Indian economy. Here also it will not be accurate to arrive at generalization just because of the adverse relationship between inflation and foreign investment. Likewise, there are some sectors like agriculture which are insensitive to foreign investment to a great extent. Hence the neutral impact of foreign investment on agriculture alone may not present a true picture about the impact of foreign investment on Indian economy in general.

All these lead to the necessity of investigating and finding out the impact of foreign investment on various macroeconomic variables of the Indian economy and measure their real depth or degree of relationship and impact with the help of various advanced statistical tests[141]. In the light of the above observations and conclusions the present study makes a modest attempt to analyse the impact of foreign investment on Indian economy and to make necessary amendments to the existing literature and update it to cope with the demands and requirements of the present economic scenario of foreign investment in India. And this attempt begins with a survey and analysis of the structure and component of foreign investment in India in the next chapter.

[141]The relationship between two variables can be placed under two categories - significant relationship and insignificant relationship. As per Regression Analysis if a test result comes below 10 percentage of probability value it will be treated as significant and vice versa. Similarly using Correlation the degree of relationship can be categorized as highly positive, positive, highly negative, negative etc.