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Relationship between Foreign Capital Flows into India and Indian Economic Growth: In the Light of Changing Financial Market Scenario

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Abstract:
Foreign capital flows includes both direct as well as indirect and these will be having larger implications on any economy for that matter particular in the light of economic development. The emerging countries of the world which are growing at good pace are believed to be dependent up to certain extent on these foreign capital flows and India is also not except from that list.Generally, there are two important effects of foreign investments on a host economy: the effect on economic growth and the effect on export performances. Both economic features are important for the transition economies' prospects. Often there exists confusion regarding whether foreign capital flows are important for economic growth are not and at the overall level it is believed to be having impact but still it is a debatable issue. An attempt has been made in this paper to examine whether there exists any relationship between foreign capital flows and the Indian economic growth in the light of changing financial market because we know that financial markets plays an very important role in development of any economy for that matter. The relationship between the two variables foreign capital flows in to India and Indian economic growth for the period from 2003-04 to 2012-13 has been established with the help of Pearson Correlation from collected data.

Keywords*: Foreign capital flows, Economic growth, Indian financial market, economic reforms*

1. Introduction

The efficient transfer of resources from those having idle resources to others who have a pressing need for them is achieved through financial markets. Stated formally, financial markets provide channels for allocation of savings to investment. These provide a variety of assets to savers as well as various forms in which the investors can raise funds and thereby decouple the acts of saving and investment. The savers and investors are constrained not by their individual abilities, but by the economy's ability, to invest and save respectively.The financial markets, thus, contribute to economic development to the extent that the latter depends on the rates of savings and investment.

The financial markets in emerging economies like India have exhibited a strong growth momentum, driven by a robust economic demand, consumption and savings rate. Although growth of the Indian economy suffered some disruption due to the economic downturn, the financial system proved its resilience with time. The Indian markets have shown quick signs of recovery, positively impacting the general global economic front.

Asian Development Bank, in its 2010 Asian Development Outlook, mentions that Developing Asia, a diverse group of 45 economies including China, India, Tajikistan, Samoa, and Indonesia, will grow 8.2% in 2010 and 7.3% in 2011. Similar to other emerging economies, India has also proved an attractive destination for investors, having exhibited a moderate growth even during the global downturn. The Financial Development Report (FDR) published by the World Economic Forum, ranks India 38 out of 55 countries, considering 120 variables like financial stability, size and depth of capital markets and business environment among others.(PWC Report; 2010)

Indian financial markets journey over last decade has been of many shades. We have seen a lot of progress, but also significant pauses. In many occasions it went to ground level and bounced back again.But it still lacksfew characteristics which a fully developed financial market will have.Presumably, it implies the starting steps of a new born baby which trying its rightful place in the Globe. The fastest free market and developing economy now is havinglots of opportunities as well as the challenges. Because of which ours trillion dollar economy is beaning called as Investor's destination. Investment might be direct or indirect but India will be in the list of highly desirable place for investment.

Capital markets in any country play a pivotal role in the growth of economy and meeting the country's socio-economic goals. They are an important constituent of the financial system given their role in the financial intermediation process and capital formation of the country. The importance of capital markets cannot be under-emphasised for a developing economy like India which needs significant amount of capital for economic development.

A financial market consists of two major segments: (a) Money Market; and (b) Capital Market.

- The money market deals in short-term credit.
- The capital market handles the medium term and long-term credit.

- **Capital Market:** It is an institutional arrangement for borrowing medium and long-term funds and which providesfacilities for marketing and trading of securities. So it constitutes all long-term borrowingsfrom banks and financial institutions, borrowings from foreign markets and raising of capitalby issue various securities such as shares, debentures, bonds, etc.

The market where securities are traded known as Securities market. It consists of two different segments namely primary and secondary market.

- The primary market deals with new or fresh issue of securities and is, therefore, also known as new issue market;
- The secondary market provides a place for purchase and sale of existing securities and is often termed as stock market or stock exchange.

Even with the case of India financial market constituted in similar way.

Very interesting and remarkable things pertaining to our financial market happened by the way of Economic Reforms-1991. Capital flows have particularly become prominent after the advent of globalization that has led to widespread implementation of liberalization programme and financial reforms in various countries across the globe in 1990's. This resulted in the integration of global financial markets. As a result, capital started flowing freely across national border seeking out the highest return. During 1991 to 1996 there was a spectacular rise in net capital flows from industrial countries to developing countries and transition economies. This development was associated with greatly increased interest by international asset holders in the emerging market economies to find trend toward the globalization of financial markets (Singh, 1998; 2002).

As stated early as Indian Financial Markets are subjected to many twists and turns the growth of Indian Economy is also fluctuated. Interestingly,though India is having a population of more than a billion, a mere 1% of the population participates in capital markets and if you are trying to be an global competitor and having a dominant position in global economy this will not help to keep pace with the other counter parts. Because, of which the concept of foreign capital has been pretty famous in country like India. But, the longstanding debate over the relationship between foreign capital inflows and economic development continues to remain an unresolved issue. A growing concern with the impact of the official lending programmes in developing economies and the catalytic effect that official lending is likely to help private flows raise a theoretical question as to how best to treat the role of foreign capital in long run economic growth.

In the neoclassical growth context, the benefits of a once-for-all foreign capital inflow (even in the form of a gift) to the host country are of a temporary nature (Crouch, 1973), as the standard model of economic growth has been mostly supply-driven within the framework of neo-classical theory in which the process of capital accumulation is driven by household savings behaviour and there is absence of aggregate demand effects that are more likely to be influenced by foreign capital. Further, the core part of the analytical framework of the financing gap models of the World Bank for funding structural adjustmentadvocates that higher investment is necessary for long-run growth. And if there is a fall in domestic demand, the role of the government in supporting demand at such a time of crisis becomes foremost important. Thus investment demand, both private and government spending, is a crucial determinant of growth. Such investment may be influenced by external financial flows, which should be considered while modelling economic growth.

These different views often make concept of economic growth and its constituents little ambiguity and this study has been majorly taken up to know whether there is any relationship between Foreign Capital Flows and the Economic Growth in the light of Changing Financial Market.

2. Review of Literature

- **'Foreign Capital in a Growth Model' - SushantaMallick and Tomoe Moore.**
  The article clearly targets on the reinvesting factors determining economic growth because there is a confusion relating to the factors which most often in particular whether growth can be described by incorporating both real capital (physical and human) and financial capital including external flows. As many low income countries continue to grow below their potential, owing to either lack of new capital or inefficient use of existing capital, a better economic performance pivots crucially on higher productive investment, which can help increase productive capacity in the long run.
- **'India's Capital Market Growth-Trends, Explanations and Evidence' – R Nagaraj.**
  This study, explains India's capital market boom, and its proximate causes. Importance of capital market for the Indian economyand to the private corporate sector as well. It is also pointed out disintermediation of household sector substituted 'shares and debentures'for bank deposits, and corporate sector securitised its debt. And also states no association between growth rates of thecapital market mobilisation and aggregate saving rate, corporate physical investment and value added later the study concludes by raising certain questions.
- **'Foreign Capital and Economic Growth' - Eswar Prasad, RaghuramRajan, and Arvind Subramanian.**
  This study, targets on contrary to the predictions of standard theoretical models, because authors point is that often non-industrial countries that have relied more on foreign finance have not grown faster in the long run. By contrast, growth and the extent of foreign financing are positively correlated in industrial countries. Authors also argue that the reason for this difference may lie in the limited ability of non-industrial countries to absorb foreign capital. Authors suggested that the current anomaly of poor countries financing rich countries may not really hurt the former's growth, at least conditional on their existing institutional and financial structures.

- **International financial flows on India's economic growth – in view of changing financial market scenario - Narayan Sethi**
  This study has mainly done in the light of applying OLS technique on foreign capital flows into India and its impact on Indian economic growth. The foreign capital flows for the study include
  FDI, FPI and FII and these are compared against Index of Industrial Production. And also stressed upon changes in Indian Financial Markets after 1990s

2.1. Research Gap

Most of the studies are done with the light of either evaluating economic growth against foreign capital flows with the help of several techniques or to reinvestigate the existing growth models to know importance foreign capital in economic growth.

A similar study has been taken up but with a major change i.e.., to evaluate the relationship between foreign capital flows and Economic Growthwith different time frame. Implies that this study is only towards knowing the relationship between the above two variables. Most of the literatures available are in magazines and Research Documents for the time frame.

3. Research Design and Methodology

This study has been done on the basis of '*Ex post Facto*' in other words descriptive research design has been adopted i.e. study has been conducted on the grounds of available data which has been collected from different sources.

3.1. Statement of the Problem

The last decade has evidenced for major changes in the Indian Financial Markets which led our economy to occupy a dominant position in the global market. This changing scenario in financial market led to entry of foreign country people to invest in Indian capital market which was giving promising returns to the investors.

But, from the view point of host countries to the investor those countries economic growth will be somewhere depending upon the foreign capital flows but the importance of foreign capital in economic growth of a country is still debatable. And most often foreign capital forms important partof any market economy for that matter and India as an emerging market economy the study towards relationship between these two variables seems to be little important.

Thus, this study has been taken up to know the relationship between the foreign capital flows and the Indian economic growth from 2007-08 to 2012-13.

3.2. Objectives of the Study

- To examine the trends and composition in the foreign capital flows.
- To know the relationship between foreign capital flows on the Indian economic growth.
- To examine the changes in financial market in recent past.

3.3. Scope of The study

This study reveals the relationship between Foreign Capital Flows into India and Indian Economic Growth and study restricted for the period of 10 years i.e. from 2003-04 to 2012-13 data pertaining to foreign capital flows and India's economic growth rate has been taken for the above said period.

3.4. Data and Methodology.

The hypothesis of positive influence of Foreign Capital Flows on Indian economic growth will be tested in this paper on the basis of Reserve Bank of India data on Foreign Capital in India. Incomparison with previously mentioned studies, this research is based on newer data and a time series, from 2003-04 to 2012-13.

- The relationship of the said variables will be tested with the help of correlation between foreign capital inflows and economic growth.

4. Data Analysis and Interpretation

4.1. Examination of the trends and composition in the foreign capital flows.

Year	FDI	FPI	FII	GDR	TOTAL
2003-04	4,322	11,356	--	--	15,678
2004-05	5,987	9,311	--	--	15,298
2005-06	8,901	--	9,926	2,552	21,379
2006-07	22,739	--	3,226	3,776	29,741
2007-08	34,728	--	20,327	6,645	61,700
2008-09	37,672	--	-15,017	1,162	23,817
2009-10	33,124	--	29,049	3,328	65,501
2010-11	11,834	--	29,422	2049	43,305
2011-12	22,061	--	16,812	597	39,470
2012-13*	19,819	--	27,582	187	47,588

Table 1: showing foreign capital flows into India from 2003-04 (US $ Million)
**Data pertaining to 2012-13 are estimated*

4.2. Examination of changes in financial market in recent past

Since the reforms of 1990s, the Indian economy has achieved acceptable growth in an environment of macroeconomic and financial stability. It is believed that the period after economic reforms has touched every segment of the economy. These reforms were designed essentially to promote greater efficiency in the economy through promotion of greater competition. It has to be accepted that though after the reforms India was exposed to many shocks (e.g., Financial Crisis of Asia, Global Recession). And appreciable thing is that stability couldbe maintained in financial markets. The India's path of reforms has been very distinct from that of its counterparts. It can be said that reforms in the financial sector andmonetary policy framework have been a key component of the overall reforms that provided thefoundation of an increased price and financial stability. The main objective of the financial sector reforms in India initiated in the early 1990s wasto create an efficient, competitive and stable financial sector that could then contribute in greatermeasure to stimulate growth.

The major reforms of the financial sector in India were as follows:

- Removal of the erstwhile existing financial repression.
- Creation of an efficient, productive and profitable financial sector
- Enabling the process of price discovery by the market determination of interest rates thatimproves allocative efficiency of resources
- Providing operational and functional autonomy to institutions
- Preparing the financial system for increasing international competition
- Opening the external sector in a calibrated manner; and
- Promoting financial stability in the wake of domestic and external shocks.

In the recent past there has been many changes in the Indian financial market and in the light of this study below paragraphs explains exclusively about Foreign Direct Investment in recent past which is being widely used.

Liberalizing foreign direct investment was another important part of India’s reforms, driven by the belief that this would increase the total volume of investment in the economy, improve production technology, and increase access to world markets. The policy now allows 100 percent foreign ownership in a large number of industries and majority ownership in all except banks, insurance companies, telecommunications and airlines. Procedures for obtaining permission were greatly simplified by listing industries that are eligible for automatic approval up to specified levels of foreign equity (100 percent, 74 percent and 51 percent). Potential foreign investors investing within these limits only need to register with the Reserve Bank of India. For investments in other industries, or for a higher share of equity than is automatically permitted in listed industries, applications are considered by a Foreign Investment Promotion Board that has established a track record of speedy decisions.

In 1993, foreign institutional investors were allowed to purchase shares of listed Indian companies in the stock market, opening a window for portfolio investment in existing companies.

The presence of foreign-owned firms and their products in the domestic market is evident and has added greatly to the pressure to improve quality. These policy changes were expected to generate faster industrial growth and greater penetration of world markets in industrial products, but performance in this respect has been disappointing.

Industrial growth increased sharply in the first five years after the reforms, but then slowed to an annual rate of 4.5 percent in the next five years. Export performance has improved, but modestly. The share of exports of goods in GDP increased from 5.7 percent in 1990-91 to 9.7 percent, but this reflects in part exchange rate depreciation. India’s share in world exports, which had declined steadily since 1960, increased slightly from around 0.5 percent in 1990-91 to 0.6 percent in 1999-2000, but much of the increase in world market share is due to agricultural exports. India’s manufactured exports had a 0.5 percent share in world markets for those items in 1990 and this rose to only 0.55 percent by 1999.

4.3. Relationship between foreign capital flows on the Indian economic growth

Year	Total Foreign Capital
2003-04	15.68
2004-05	15.30
2005-06	21.38
2006-07	29.74
2007-08	61.70
2008-09	23.83
2009-10	65.51
2010-11	43.31
2011-12	39.47

Table 2: showing foreign capital into India from 2003-04 (US $ Billion)

Year	Growth Rate (%)
2004-05	7.60
2005-06	9.49
2006-07	9.60
2007-08	9.30
2008-09	6.70
2009-10	8.40
2010-11	8.39
2011-12	6.88
2012-13*	4.60

Table 3: showing GDP Growth Rate at Factor cost of India from 2004-05
**Data pertaining to 2012-13 are estimated*

4.4. Results

The correlation of Foreign capital inflows and economic growth rates is tested. It is known that any investment has impact on production only after some time, the test of correlation between Foreign capital inflowsin one year and economic growth rates and growth rate in the next year. Results are given below:

- **For the period of 2003-04 to 2012-13**
  The value of correlation(R) is -0.4148. Although technically a negative correlation exists, the relationship between the variables is only week. The value of Coefficient of determination is 0.1721.
- **For the period of 2007-08 to 2012-13**
  The value of correlation(R) is 0.0693. Technically a positive correlation exists, the relationship between the variables is only week. The value of Coefficient of determination is 0.0048.

5. Findings and Conclusion

As is obvious, there is a wide variability of correlation and coefficient of determination. Thus, it can be conclude that there are no significant statistical relationships between influxes of foreign capital and growth rates. Further statisticalanalyses confirm this attitude, but are not included in this paper.

However, the method presented has a serious defect. The same value of foreign capital hasa different effect. And in the above calculations during the period from 2003-04 to 2012-13 has negative correlation where as for the period from 2007-08 to 2012-13 has positive correlation.

The Foreign Direct Investment (FDI) has huge contribution to influence the economic behaviour is also affects the economic growth to very good extent. The Foreign Portfolio Investment (FPI) is indirectly affecting the economic growth. But whatever might be the results arrived, it is very much clear that foreign capital flows will be having impact on the any economy for that matter and the biggest problem for the emerging economies is the investment and to overcome this problem they have to resort on foreign capital flows itself. And India as a predominant global player it cannot resist itself from the developing happening around her, to have good pace with other countries and to achieve economic development foreign capital plays vital role.

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