## Foreign direct investment

6.43 In the schema of classification of capital flows based on duration, FDI has been the most attractive type of capital flows for emerging market economies because of its lasting nature and also because it is considered a vehicle for transformation of the domestic production process through bridging the technological gap. Concerted efforts towards attracting FDI through an emphasis on policies of promoting non-debt creating capital inflows during the reform period did not yield results on the expected lines initially.

6.44 With reform in policies, better infrastructure and a more vibrant financial sector, FDI inflows into India accelerated in 2006-07. On a gross basis, FDI inflows into India, after rising to a level of US$ 6.2 billion in 2001-02, fell to US$ 4.5 billion in 2003-04. After a recovery, the proportion has risen to reach US$ 23.0 billion in 2006-07. The trend continued in the current financial year with gross FDI flows at US$ 11.2 billion in the first six months. FDI inflows continued to be preponderantly of the equity variety, broad-based and spread across a range of economic activities like financial services, manufacturing, banking services, information technology services and construction.

6.45 FDI grew appreciably on both gross and net basis. While on a gross basis, the growth in 2006-07 was 150.2 per cent, on a net basis it was 179.5 per cent. Even as FDI into India (credit side) grew substantially, a simultaneous pick up in outward investment moderated the overall net inflows. Outward investment by India shot up from levels less than US$ 2.4 billion in the period 2003-04 to 2004-05 to reach US$ 14.4 billion in 2006-07. Thus, overall net FDI in 2006-07 was at US$ 8.5 billion. The trend continued in the current year also with FDI inflows in the period April-September 2007 being moderated by outward investment of US$ 7.3 billion to yield net flows of US$ 3.9 billion. The proportion of payments to receipts under FDI into India was 0.7 per cent and 0.4 per cent in 2005-06 and 2006-07, respectively. This indicates the lasting and stable nature of FDI flows in India.

## Portfolio investment

6.46 With greater openness in the emerging market economies and developing countries, portfolio investment flows became net outflows in four out of the last six years ending 2006. According to the WEO, private net portfolio flows to these economies, after being overall outflows in the period 2001-03, recorded modest levels of positive inflows of US$ 21.1 billion and US$ 23.3 billion in 2004 and 2005, respectively. The year 2006 witnessed a great reversal with a massive net outflow of US$ 111.9 billion. The reversal in emerging Asia was the highest with an outflow of US$ 120.8 billion in 2006. There was no such outflow from India in 2006, though the level of portfolio inflows was lower than in 2005.

6.47 With heightened volatility in Asian and global financial markets in 2006-07, net portfolio inflows into India amounted to US$ 7.1 billion for 2006-07. Portfolio net flows after being negative in the initial months (May-July 2006) picked up momentum in August-November 2006 only to slow down again in March 2007. Euro equities, which were relatively a very small component of portfolio flows (less than US$ 1 billion in the period 1997-98 to 2004-05), have risen in 2005-06 and 2006-07 to reach US$ 2.6 billion and US$ 3.8 billion, respectively. In 2006-07, Euro equities constituted 54.3 per cent of the total portfolio net flows. However, this composition was more due to lower net inflows under FII. Portfolio investment inflows in the first six months was US$ 83.4 billion and outflows was US$ 65 billion leaving a net inflow of US$ 18.3 billion, which implies a growth of 1,015.2 per cent, year-on-year.

6.48 In the schema of classification based on duration, portfolio investment flows fall under short-term variety. The proportion of net portfolio outflows to total portfolio flows under this head indicates the nature of such flows. In the seven-year period from 2000-01, the proportion of net flows to total gross flows (inflows plus outflows) were below 13 per cent, with the exception of 2003-04 when it was higher at 25.2 per cent. In 2006-07, the proportion was abysmally low at 3.3 per cent (Table 6.14).

6.49 An analysis of the monthly data on net FII inflows released by the Securities and Exchange Board of India (SEBI) also indicates similar volatility. For instance, the standard deviation (a statistical measure of dispersion indicating how widely the values of the data set are spread; a larger standard deviation means greater dispersion) of the net inflows under FII was very high (US$ 2,423.4

**Table 6.14 Portfolio net flows as a proportion of total portfolio flows**

| Year | In US$ million | | | | In per cent |
|---|---|---|---|---|---|
| | Credit | Debit | Net | Total (2+3) | proportion (4/5) |
| 1 | 2 | 3 | 4 | 5 | 6 |
| 2000-01 | 13619 | 11029 | 2590 | 24648 | 10.5 |
| 2001-02 | 9259 | 7307 | 1952 | 16566 | 11.8 |
| 2002-03 | 8833 | 7889 | 944 | 16722 | 5.7 |
| 2003-04 | 28218 | 16862 | 11356 | 45080 | 25.2 |
| 2004-05 | 40847 | 31560 | 9287 | 72407 | 12.8 |
| 2005-06 | 68120 | 55626 | 12494 | 123746 | 10.1 |
| 2006-07 | 109622 | 102560 | 7062 | 212182 | 3.3 |

**Source: RBI.**

million) in the 12 months ending December 2007. The same measure for 24 months ending December 2007 yielded a somewhat lower (US$ 1,882.8 million) dispersion. In terms of another statistical measure, namely coefficient of variation (indicates the variation in a set of values around its average; a coefficient above 1 indicates higher variation), the SEBI data yields results of 1.69 and 1.79 for the 12 and 24 months period ending December 2007. Notwithstanding the fact that portfolio investment flows have been volatile, there has not been any significant net outflow for the year as a whole in the post-reform period, except in 1998-99.

## Other non-debt flows

6.50 In the BoP system of accounts of the RBI, the head "Other Capital" covers mainly the leads and lags in export receipts (the difference between the custom data and the banking channel data), funds held abroad, and the residual item of other capital transactions not included elsewhere such as flows arising from cross-border financial derivative and commodity hedging transactions, migrant transfers, and sale of intangible assets such as patents, copyrights, trademarks, etc. In 2006-07, Other Capital (net) including banking capital amounted to US$ 8.8 billion. Payments transaction like short-term credits, which earlier were not captured explicitly elsewhere, were accounted under this residual head implicitly. In its Press Release dated December 29, 2007, reporting BoP developments for the second quarter, the RBI had, among other things, indicated some accounting changes in this head (Box 6.1).

6.51 As per the RBI's revised data on Other Capital, leads and lags in export payments, which was negative in 2005-06 and less than a billion US dollars in 2006-07, shot up in April-September 2007 and reached US$ 3.7 billion. In 2007-08, advance received for effecting FDI (pending with authorized dealers) amounted to US$ 2 billion. With other residual capital of the order of US$ 2.1 billion, total net flows under Other Capital head was of the order of US$ 6 billion.

### Box 6.1 Changes in the BoP system of recording

The RBI, in conformity with the best international practices and as per the provisions of Balance of Payments Manual 5 (BPM5) of the IMF, made certain changes in the system of recording BoP flows. In the earlier system of recording of international transactions between residents and non-residents, trade credits or credits for financing imports by Indian residents extended by foreign suppliers up to 180 days were not covered explicitly and were subsumed under the head 'Other Capital' or errors and omissions. However, such credit beyond 180 days was recorded and reported. Usually very short-term credit less than 180 days get rolled over within a year and as such they are recorded on a net basis only. However, using the internationally accepted methodology as recommended in BPM5, the RBI started recording these transactions for both BoP and external debt purposes. While in the case of BoP there was no change in the overall balance as other capital and errors and omissions were lower to the extent that short-term credits were higher, total stock of outstanding external debt went up (details in the subsequent section on external debt).

Transactions by non-resident Indians (NRIs) in the Non-Resident Ordinary (NRO) account were earlier included under 'Other Capital' in the capital account. The RBI has put in place a reporting system and record these data separately. As such, transactions under the NRO account have now been included under NRI deposits. Besides, the RBI, taking cognizance of the importance of the services in invisibles account and the possibility of some overlap between business services and software services of the ITES variety, had reviewed the data reported by authorized dealers and revised the business services data and started providing greater details of the non-software services. The methodology of the revision was detailed in its Press Release dated December 31, 2007.