Capital account

6.30 Capital inflows can be classified by instrument (debt or equity) and maturity (short-term or long-term). The main components of capital account include foreign investment, loans and banking capital. Foreign investment comprising foreign direct investment and portfolio investment represents non-debt liabilities, while loans (external assistance, external commercial borrowings and trade credit) and banking capital including non-resident Indian deposits are debt liabilities.

6.31 Net capital flows rose from a level of US$ 45.2 billion in 2006-07 to US$ 108.0 billion in 2007-08, indicating a growth of 139 per cent, attributable to a significant rise in foreign investment in term of direct and portfolio investment, large inflow of banking capital and a quantum jump in loans, particularly short-term credit and external commercial borrowings (net). However, the net capital inflow during 2008-09 (April-December) was only US$ 15.3 billion.

Non-debt flows

Foreign investment

6.32 The foreign investment comprising foreign direct investment (FDI) and portfolio investment on net basis was US$ 14.8 billion in 2006-07 and US$ 45.0 billion in 2007-08 (204.7 per cent growth), before slowing down to US$ 4.0 billion during 2008-09 (up to Q3). As a proportion of total capital flows, net foreign investment stood at 41.6 per cent in 2007-08 (32.6 per cent in 2006-07). However, its share declined to 26.4 per cent during 2008-09 (April-December) on account of FII outflows as a result of the global financial crisis (Box 6.3).

Foreign direct investment

6.33 FDI is considered to be the most attractive type of capital flow for emerging economies as it is expected to bring latest technology and enhance production capabilities of the economy.

6.34 During 2005-06 to 2008-09, FDI flows assumed greater significance. High inflows indicate India as an attractive investment destination as a consequence of its liberalised investment climate (Box 6.3), stable and sound economic and political base, opportunities for economic growth, while capital investment abroad reflects the growing global competitiveness of the Indian corporate sector. The two-way flow of FDI, therefore, means that while the world is taking note of India's market potential, Indian companies are also constantly looking for synergistic acquisitions abroad.

6.35 With the reforms in policies, better infrastructure and vibrant financial sector, FDI inflows into India have accelerated since 2006-07. On a gross basis, FDI inflows into India increased from US$ 8.9 billion in 2005-06 to US$ 22.8 billion in 2006-07 and further to US$ 34.4 billion in 2007-08. In the fiscal 2008-09 (April-December) gross FDI into India was US$ 27.5 billion. FDI inflows are spread across a range of economic activities like financial services, manufacturing, banking services, information technology services and construction.

6.36 FDI has grown significantly on net basis. The year-to-year growth in FDI (net) was 153.6 per cent in 2006-07 and 100.2 per cent during 2007-08. Even as FDI flows into India grew substantially, a simultaneous pick up in outward investment moderated the overall net inflows. Outward investment by India increased from less than US$ 2.4 billion during 2003-04 and 2004-05 to US$ 15.8 billion in 2006-07 and US$ 21.3 billion in 2007-08.

6.37 During fiscal 2008-09 (April-December), FDI into India (net) remained buoyant at US$ 27.4 billion (US$ 20.0 billion in April-December 2007) reflecting relatively better investment climate in India and the continuing liberalization measures to attract FDI. Outward FDI (net) continued to remain high at US$ 12.0 billion during April-December 2008 even in the current economic situation, though it was marginally lower than its previous year's level of US$ 13.1 billion. Due to large inward flows, the net FDI (inward minus outward FDI) was higher at US$ 15.4 billion in April-December 2008, as compared with US$ 6.9 billion in April-December 2007.

Portfolio investment

6.38 Portfolio investment includes foreign institutional investors (FIIs) investment, issue of global depository receipts (GDRs)/American depository receipts (ADRs) and offshore funds. Net portfolio inflows into India was US$ 7.0 billion in 2006-07 and

Box 6.3 : Foreign Direct Investment

As per the United Nations Conference on Trade and Development (UNCTAD) report titled "Assessing the Impact of the Current Financial and Economic Crisis on Global FDI Flows" India achieved a growth of 85.1 per cent in FDI inflows which was the highest globally. The total flows increased from US$ 25.1 billion in 2007 to US$ 46.5 billion in 2008. This is despite 14.5 per cent decline in global FDI inflows from US$ 1,940.9 billion in 2007 to US$ 1,658.5 billion in 2008. India also ranked 9th in global FDI inflows in 2008. A comparative statement is given below:

Rank in 2008	Countries	2007	2008*	Growth rate (%)
1	USA	232.8	320.9	37.8
2	France	158.0	126.1	-20.2
3	UK	196.4	96.8	-50.7
4	Belgium	70.0	94.2	34.6
5	China	83.5	92.4	10.6
6	Russia	52.5	70.3	34.0
7	Spain	68.8	65.5	-4.8
8	Hong Kong China	59.9	63.0	5.2
9	India	25.1	46.5	85.1
10	Brazil	34.6	45.1	30.3
11	Sweden	22.1	40.4	83.1
	World	**1940.9**	**1658.5**	**-14.5**

* **preliminary estimates**

In terms of UNCTAD Survey 2008-10, China is the most preferred investment destination, followed by India, the United States, the Russian federation and Brazil. Similarly, AT Kearney's 2007 FDI Confidence Index shows China, India and USA as the most preferred locations in that order. For long-term prospects, JBIC survey of Japanese manufacturing Transnational Corporations (TNCs) showed India replacing China as the most promising country for business operations of Japanese TNCs.

Robust economic growth, an improved investment environment and opening up of critical sectors like telecommunications, civil aviation, refineries, construction, etc facilitated FDI inflows into India.

Reference: UNCTAD report titled "Assessing the Impact of the Current Financial and Economic Crisis on Global FDI Flows"; and World Investment Report 2008.

US$ 29.4 billion in 2007-08. Portfolio investment by FIIs however witnessed large net outflows of US$ 12.4 billion during April-December 2008 (as against net inflows of US$ 24.5 billion in April-December 2007) due to large scale sale of equities by FIIs in the Indian stock market. As per data available for the full year 2008-09, FII outflows amounted to US$ 15 billion vis-à-vis net inflow of US$ 20.3 billion during the year 2007-08.

6.39 The FII flows have exhibited significant volatility as measured by the ratio of net inflows to total inflows during 2003-04 to 2008-09. It remained in the range of 6.4 per cent to 40.2 per cent. During April-December 2008, net inflows turned negative while the total inflows were sizeable at US$ 109.9 billion (Table 6.5).

Other non-debt flows

6.40 The head "Other Capital" in "BoP" covers mainly the leads and lags in export receipts (the difference between the customs data and the banking channel data), funds held abroad, and other capital

Table 6.5 : Portfolio flows (net) as a proportion of inflow (US$ million)

Year	Inflow	Outflow	Net	Proportion (in per cent)
2003-04	28218	16862	11356	40.2
2004-05	40847	31560	9287	22.7
2005-06	68120	55626	12494	18.3
2006-07	109622	102560	7062	6.4
2007-08	235924	206368	29556	12.5
2008-09 (up to Q3)	109993	121334	(-) 11341	(-) 10.31

Source : RBI

transactions not included elsewhere such as flows arising from cross-border financial derivative and commodity hedging transactions, and sale of intangible assets such as patents, copyrights, trademarks, etc. In the year 2006-07, "Other Capital (net)" was placed at US$ 4.2 billion, which increased to US$ 9.5 billion in 2007-08 and was US$ 1.9 billion during April-December 2008.

Debt flows

External commercial borrowings (ECBs)

6.41 Management of debt flows, including private flows from ECB sources, have been guided by the overarching principles of prudent external debt management. This focuses on keeping the maturities long and servicing cost low. ECBs are approved within the overall annual ceiling that is revised upwards progressively, subject to a hierarchy of priorities for projects/sectors. With relative stability and strong capital inflows, liberalization of ECB norms has been in the nature of allowing corporates to borrow up to a certain limit under the "automatic route". ECB policy has been liberalized in terms of expanding the list of eligible borrowers, end-use of funds raised through ECBs and terms of raising ECBs to counter the effect of global crisis (Box 6.4).

Box 6.4 : Recent initiatives to liberalize ECBs

A number of policy initiatives have been taken to liberalize the external commercial borrowings to counter the negative fallout of declining investment flows. The chronology of liberalization measures is as under:

- Borrowers in infrastructure sector were allowed to avail ECBs up to US$ 100 million for Rupee expenditure for permissible end-uses under the approval route (May 29, 2008). The limit was enhanced to US$ 500 million per year for the borrowers in the infrastructure sector under the approval route (September 22, 2008). The requirement that borrowings in excess of US$ 100 million for Rupee capital expenditure in the infrastructure sector should have a minimum average maturity of 7 years was also dispensed with (October 22, 2008).
- The existing limit of US$ 20 million for Rupee expenditure for permissible end-uses for borrowers (other than those in the infrastructure sector) under the approval route was enhanced to US$ 50 million (May 29, 2008).
- Banks were permitted to allow payment of lease rentals, opening of letters of credit towards security deposit etc. in respect of import of aircraft/aircraft engine/helicopter on operating lease basis (July 2008). Banks have also been allowed to convey "no objection" from the Foreign Exchange Management Act (FEMA), 1999 angle for issue of corporate guarantee in favour of the overseas lessor, for operating lease in respect of import of aircraft/aircraft engine/helicopter (April 20, 2009).
- ECBs up to US$ 500 million per borrower per financial year were permitted for rupee and/or foreign currency expenditure for permissible end-uses under the automatic route (October 22, 2008).
- Payment for obtaining licence/permit for 3G Spectrum will be considered as an eligible end-use for the purpose of ECB (October 22, 2008).
- Systemically important non-deposit taking NBFCs have been temporarily permitted to raise short-term foreign currency borrowings under the approval route, subject to their complying with the prudential requirements of capital adequacy and exposure norms (October 31, 2008).
- Housing finance companies, registered with National Housing Bank, have been permitted to raise short-term foreign currency borrowings under the approval route (November 15, 2008).
- Non-banking financial companies (NBFCs), which are exclusively involved in financing of the infrastructure sector, have been allowed to avail of ECBs from multilateral/regional financial institutions and Government-owned development financial institutions for on-lending to the borrowers in the infrastructure sector under the approval route (January 2, 2009).
- Corporate in the services sector viz., hotels, hospitals and hoftware companies which were hitherto allowed to avail of ECB up to USD 100 million per financial year for import of capital goods under the approval route have been permitted to avail ECB up to USD 100 million per year for both foreign currency and/or Rupee capital expenditure for permissible end-use, other than for land acquisition, under the automatic route (January 2, 2009).
- Corporates engaged in the development of integrated township have been permitted to avail of ECB under the approval route (January 2, 2009).
- With effect from January 2, 2009, the requirement of all-in-cost ceilings on ECB has been dispensed with until June 30, 2009. Eligible borrowers proposing to avail of ECB beyond the permissible all-in-cost ceilings of six month Libor+300 bps and six-month Libor+500 bps for ECBs for average maturity period of three-five years and more than five years respectively are required to approach the Reserve Bank of India under the approval route.
- The limit for FII investment in Government securities was enhanced from US$ 3.2 billion to US$ 5 billion and that for corporate debt from US$ 1.5 billion to US$ 3.0 billion from June 6, 2008; the latter was enhanced further to US$ 6 billion and US$ 15 billion with effect from October 16, 2008 and January 2, 2009 respectively.

6.42 In the last three years, ECB receipts have grown at high rates of 57.9 per cent in 2005-06, 45.6 per cent in 2006-07 and 45.5 per cent in 2007-08. In the same period, repayments have exhibited high volatility with high growth of 204.2 per cent owing to a one-off effect of redemption of India Millennium Deposits (IMD) in 2005-06, followed by a decline of 59.6 per cent in 2006-07 and an increase of 62 per cent in 2007-08. The net inflows under ECBs have therefore been uneven during 2005-06 to 2007-08. Net flows increased to US$ 16.1 billion in 2006-07 from US$ 2.5 billion in 2005-06 and further to US$ 22.6 billion in 2007-08. Net external commercial borrowings (ECBs) slowed down to US$ 7.1 billion in April-December 2008 (US$ 17.4 billion in April-December 2007) mainly due to tight liquidity conditions in the overseas markets.

6.43 In 2006-07, net ECBs accounted for 34.8 per cent of total capital account net flows, which declined to 21 per cent in 2007-08. ECB inflows in the recent past have been enabled by favourable global liquidity conditions, rising credit needs, interest differential and currency expectations.

Short-term credits, non-resident deposits and external assistance

6.44 While ECBs were the dominant source and constituted 65.8 per cent of the debt flows in 2006-07 and 54.0 per cent in 2007-08, the other debt flows comprising the non-resident deposits, short-term loans and external assistance were also important as they had specific functional roles in the financing trade and development.

6.45 The short-term trade credit (net) was US$ 17.2 billion in 2007-08. Net short-term trade credit stood at US$ 0.5 billion (inclusive of suppliers' credit up to 180 days) during April-December 2008 as compared with US$ 10.7 billion during the corresponding period of 2007-08.

6.46 Non-resident deposits constitute an important source of capital flows. Net NRI deposits increased from US$ 3.7 billion in 2005-06 to US$ 4.3 billion in 2006-07 but fell to US$ 0.2 billion in 2007-08. NRI deposits witnessed a net inflow of US$ 2.1 billion in April-December 2008, a turnaround from

Table 6.6 : Non-resident deposits under different schemes

(US$ million)

Part A: Outstanding balances under different schemes

Scheme	As the end of March							
	2003	2004	2005	2006	2007	2008	Dec 2007	Dec 2008
Foreign currency non-resident (banks) FCNR (B)	10199	10961	11452	13064	15129	14168	14758	12936
Non–resident (external) rupee account (NR(E)RA)	14923	20559	21291	22070	24495	26716	26078	23226
Non-resident (non-repatriable) rupee deposits (NR(NR)RD)	3407	1746	232	-	-	-	-	-
Non-resident ordinary rupee account (NRO)	-	-	-	1148	1616	2788	2198	4134
Total	**28529**	**33266**	**32975**	**36282**	**41240**	**43672**	**43034**	**40296**

(US$ million)

Part B : Net flows under non-resident deposits

Scheme	2003-04	2004-05	2005-06	2006-07	2007-08	2007-08	2008-09
						April-December	
Foreign currency non-resident (banks) FCNR (B)	762	492	1612	2065	-960	-371	-1232
Non-resident (external) rupee account (NR(E)RA	4695	84	1177	1830	109	-960	1383
Non-resident (non-repatriable) rupee deposits (NR(NR)RD)	-1816	-1538	-	-	-	-	-
non-resident ordinary rupee account (NRO)	-	-	930	426	1030	400	1963
Total	**3641**	**-962**	**3719**	**4321**	**179**	**-931**	**2114**

Source : RBI

net outflow of US$ 0.9 billion in April-December 2007. The outstanding amount under various NRI deposit schemes also increased from US$ 41.2 billion at end-March 2007 to US$ 43.7 billion at end-March 2008 (Table 6.6).

6.47 External assistance (net), which had increased from US$ 1.9 billion in 2006-07 to US$ 2.1 billion in 2007-08, was US$ 1.9 billion during April-December 2008.

Capital account balance

6.48 The capital account surplus has increased over the years from US$ 24.9 billion (3.1 per cent of GDP) in 2005-06 to US$ 46.1 billion (5.1 per cent of GDP) in 2006-07 and further to US$ 109.1 billion (9.3 per cent of GDP) in 2007-08. Capital account balance of US$ 16.1 billion (1.8 per cent of GDP) during 2008-09 (up to Q3) represented a decline of 80.5 per cent from US$ 82.7 billion during the corresponding period in 2007-08.

6.49 During Q3 of 2008-09, the capital account balance turned negative indicating a net outflow of US$ 3.7 billion, as against an inflow of US$ 31.0 billion in Q3 of 2007-08 attributable to net outflow under portfolio investment, banking capital and short-term trade credit. Net ECBs remained lower at US$ 3.9 billion in Q3 of 2008-09 (US$ 6.2 billion in Q3 of 2007-08), as the liquidity conditions tightened in the international financial markets and external commercial borrowings became more expensive. Short-term trade credit witnessed a net outflow of US$ 3.1 billion as against an inflow of US$ 4.1 billion in Q3 of 2007-08. Net FDI flows (inward FDI minus outward FDI) was US$ 0.8 billion in Q3 of 2008-09 (US$ 2.0 billion in Q3 of 2007-08). There was, however, a turnaround in the inflows under the NRI deposits to US$ 1.0 billion during Q3 of 2008-09 (an outflow of US$ 0.9 billion during Q3 of 2007-08), which responded to the hike in ceiling interest rates on NRI deposits.