UNIT - 5: INTERNATIONAL CAPITAL MOVEMENTS

TYPES OF FOREIGN CAPITAL

The term 'foreign capital' is a comprehensive one and includes any inflow of capital into the home country from abroad. Foreign capital may flow into an economy in different ways. Some of the important components of foreign capital flows are:

1. Foreign aid or assistance which may be:
(a) Bilateral or direct inter government grants.
(b) Multilateral aid from many governments who pool funds with international organizations like the World Bank.
(c) Tied aid with strict mandates regarding the use of money or untied aid where there are no such stipulations
(d) Foreign grants which are voluntary transfer of resources by governments, institutions, agencies or organizations.

2. Borrowings which may take different forms such as:
(a) Direct inter government loans
(b) Loans from international institutions (e.g. world bank, IMF, ADB)
(c) Soft loans for e.g. from affiliates of World Bank such as IDA
(d) External commercial borrowing, and
(e) Trade credit facilities

3. Deposits from non-resident Indians (NRI)

4. Investments in the form of :
(i) Foreign portfolio investment (FPI) in bonds, stocks and securities, and
(ii) Foreign direct investment (FDI) in industrial, commercial and similar other enterprises

FOREIGN DIRECT INVESTMENT (FDI)

- Foreign direct investment (FDI), according to IMF manual on 'Balance of payments' is "all investments involving a long-term relationship and reflecting a lasting interest and control of a resident entity in one economy in an enterprise resident in an economy other than that of the direct investor".
- This typically occurs through acquisition of more than 10 percent of the shares of the target asset .

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- FDI has three components, viz.,

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👉 equity capital,
👉 reinvested earnings and
👉 other direct capital in the form of intra-company loans between direct investors (parent enterprises) and affiliate enterprises

- The main forms of direct investments are:

👉 the opening of overseas companies, including the establishment of subsidiaries or branches, creation of joint ventures on a contract basis, joint development of natural resources and purchase or annexation of companies in the country receiving foreign capital.

- Direct investments are real investments in factories, assets, land, inventories etc. and involve foreign ownership of production facilities.

- Based on the nature of foreign investments, FDI may be categorized as horizontal, vertical or conglomerate.

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i) A horizontal direct investment is said to take place when the investor establishes the *same type of business operation* in a foreign country as it operates in its home country, for example, a cell phone service provider based in the United States moving to India to provide the same service.

ii) A vertical investment is one under which the investor establishes or acquires a business activity in a foreign country which is different from the investor's main business activity yet in some way supplements its major activity. For example; an automobile manufacturing company may acquire an interest in a foreign company that supplies parts or raw materials required for the company.

iii) A conglomerate type of foreign direct investment is one where an investor makes a foreign investment in a business that is unrelated to its existing business in its home country. This is often in the form of a joint venture with a foreign firm already operating in the industry, as the investor has no previous experience.

👉Yet another category of investment is 'two- way direct foreign investments' which are reciprocal investments between countries. These investments occur when some industries are more advanced in one nation (for example, the computer industry in the United States), while other industries are more efficient in other nations (such as the automobile industry in Japan).

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FOREIGN INVESTMENT PORTFOLIO (FPI)

- Foreign portfolio investment is the flow of what economists call 'financial capital' rather than 'real capital' and does not involve ownership or control on the part of the investor.

- Examples of foreign portfolio investment are the deposit of funds in an Indian or a British bank by an Italian company, the purchase of a bond (a certificate of indebtedness) of a Swiss company or the Swiss government by a citizen or company based in France.
- Unlike FDI, portfolio capital, in general, moves to investment in financial stocks, bonds and other financial instruments and is effected largely by individuals and institutions through the mechanism of capital market.
- These flows of financial capital have their immediate effects on balance of payments or exchange rates rather than on production or income generation.

- Foreign portfolio investment (FPI) is not concerned with either manufacture of goods or with provision of services.

- Logically, portfolio capital moves to a recipient country which has revealed its potential for higher returns and profitability.

- Following international standards, portfolio investments are characterised by lower stake in companies with their total stake in a firm at below 10 percent.
- It is also noteworthy that unlike the FDIs, these investments are typically of short term nature, and therefore, are not intended to enhance the productive capacity of an economy by the creation of capital assets.

- Portfolio investments are, to a large extent, expected to be speculative

Foreign direct investment (FDI) VS Foreign portfolio investment (FPI)

Foreign Direct Investment (FDI)	Foreign Portfolio Investment (FPI)
Investment involves creation of physical assets	Investment is only in financial assets
Has a long term interest and therefore remain invested for long	Only short term interest and generally remain invested for short periods
Relatively difficult to withdraw	Relatively easy to withdraw
Not inclined to be speculative	Speculative in nature
Often accompanied by technology transfer	Not accompanied by technology transfer
Direct impact on employment of labour and wages	No direct impact on employment of labour and wages
Enduring interest in management and control	No abiding interest in management and control
Securities are held with significant degree of influence by the investor on the management of the enterprise	Securities are held purely as a financial investment and no significant degree of influence on the management of the enterprise

REASONS FOR FOREIGN DIRECT INVESTMENT

- **The chief motive for shifting of capital between different regions or between different industries is the expectation of higher rate of return than what is possible in the home country.**

Investments move across borders on account of:

- **The increasing interdependence of national economies** - MNG
- **Internationalisation of production and investment of transnational corporations in their subsidiaries and affiliates**
- **Desire to reap economies of large-scale operation arising from technological growth**

- Desire to procure a promising foreign firm to avoid future competition
- Risk diversification so that recessions or downturns may be experienced with reduced severity
- Desire to capture large and rapidly growing high potential emerging markets with substantially high and growing population
- Stable political environment and overall favourable investment climate in the host country
- Desire to secure access to minerals or raw material deposits located elsewhere and earn profits through processing them to finished form (Eg.FDI in petroleum)
- The existence of low relative wages in the host country because of relative labour abundance
- Lower level of economic efficiency in host countries and identifiable gaps in development.
- Tax differentials and tax policies of the host country which support foreign direct investment.

Factors in the host country discouraging inflow of foreign investments are

- infrastructure lags,
- high rates of inflation,
- poor literacy and low labour skills,
- rigidity in the labour market,
- bureaucracy and corruption,
- unfavourable tax regime,
- cumbersome legal formalities and delays,
- land acquisition issues,
- small size of market and lack of potential for its growth,
- political instability, absence of well-defined property rights, exchange rate volatility, poor track-record of investments, prevalence of non-tariff barriers, stringent regulations, lack of openness, language barriers, high rates of industrial disputes, lack of security to life and property, double taxation and lack of a general spirit of friendliness towards foreign investors.

MODES OF FOREIGN DIRECT INVESTMENT (FDI)

Foreign direct investments can be made in a variety of ways, such as:
(i) Opening of a subsidiary or associate company in a foreign country,
(ii) Equity injection into an overseas company,
(iii) Acquiring a controlling interest in an existing foreign company,
(iv) Mergers and acquisitions(M&A)
(v) Joint venture with a foreign company.
~~(vi)~~ Green field investment (establishment of a new overseas affiliate for freshly starting production by a parent company).
~~(vii)~~ Brownfield investments (a form of FDI which makes use of the existing infrastructure by merging, acquiring or leasing, instead of developing a completely new one.
For e.g. in India 100% FDI under automatic route is allowed in Brownfield Airport projects.

FOREIGN DIRECT INVESTMENT IN INDIA

- India's FDI inflows reached record levels during 2020-21. The total FDI inflows stood at US$ 81,973 million, a 10% increase over the previous financial year.

- According to the World Investment Report 2022, India was ranked eighth among the world's major FDI recipients in 2020, up from ninth in 2019.

Information and technology, telecommunication and automobile were the major receivers of FDI in FY22.