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Capital Inflows and Its Effects on Macro Economic Growth in India

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ABSTRACT

The last decade has witnessed a tremendous increase in the mobility of international capital. Cross-country trends in capital flows reveal that private capital flows now dominate with official capital flows reduced to a trickle. Simultaneously, arise in portfolio capital has tilted the composition of international capital flows towards short-term investments, exposing individual countries to enhanced volatility and sudden withdrawal risks. These have been driven both by strong trends towards globalization, which has enabled pursuit of higher returns and portfolio diversification, and the market oriented reforms in many countries, which have liberalized access to financial markets. Concurrent with these trends has been the rising incidence of financial crises, raising questions about linkages between the two. Concern has also been expressed as to whether the costs of increased vulnerability to financial fragility might not outweigh the gains from financial integration. Notwithstanding these doubts, most countries continue to progress in dismantling capital controls to integrate their financial markets with the rest of the world, albeit more cautiously.

1.INTRODUCTION

These developments have stimulated a keen interest in understanding the nature and economic effects of capital flows as well as the appropriate policy responses to safeguard against financial instability that appears to be associated with international capital mobility. Capital flows affect a wide range of economic variables such as exchange rates, interest rates, foreign exchange reserves, domestic monetary conditions as well as savings and investments. Some commonly observed effects of capital inflows that have been documented in recent studies1 include real exchange rate appreciation, stock market and real estate boom, reserve accumulation, monetary expansion as well as effects on production and consumption. Empirical studies that have begun to appear onthe subject assess the impact of capital inflows upon output growth (Gruben and McLeod,1962), differential macroeconomic effects of portfolio and foreign direct investment(Gunther, Moore and Short, 1996) and effects upon monetary conditions, savings and investment (Kamin and Wood, 1998).

The experience of capital account liberalization elsewhere suggests that opening domestic financial markets to international capital flows exacerbates imprudent practice under weak regulation or regulatory forbearance. The large accumulation of reserves by RBI provides insurance against rapid capital outflows but at the loss of foreign interest earnings (Khanna, 2002).The rapid liberalization of financially repressed economy often leads to large capital and rapid expansion of domestic financial market followed by a capital account crisis and economic contraction. The elimination of capital controls exposes domestic capital markets and macro-

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economic policies to discipline of international capital market, starting a race between financial reforms and crash. Indian policy is following determined gradual path towards economic liberalization and international integration. Following the liberalization of transaction on the current account, restrictions on capital inflows have been relaxed steadily with an emphasis on encouraging long-term vestment and saving.

The pattern of liberalization capital inflows in India has been the gradual raising of quantitative restriction on inflows and the size of flows that automatically approved. The gradual relaxation on restriction on capital outflows would logically follow, while restriction that discourages short-term inflow, which are the parts of current policy. Capital control means that the Government borrows on captive domestic financial market regardless of financial reforms on date. International financial integration typically leads to both inward and outward gross capital flows. Gross capital flows are indeed are much larger internationally then are net capital flows; with capital account, India could well experience a large outflow of domestic saving from high cost domestic financial intermediaries to international capital markets. The process of opening the Indian economy to foreign capital inflows is not complete and making India more attractive to FDI require more than the relaxation of constraints on inflows and foreign ownership. Domestic policy distortions and regulatory uncertainty can inhibit investment flows, perhaps significantly. Opening up capital account to outflow could also enhanced (Chitre, 1996).

ISSUES/PROBLEM OF THE STUDY

In this context, our earlier discussion arises the question whether the international capital flows have been successfully increasing the growth of the economy and in particular whether they have lead to greater efficient financial markets. That is what provides them motivation for the present study. The present study tried to make a preliminary attempt to test whether international capital flow helps to integrate domestic financial markets withnternational financial markets and also whether international capital flows has the positive impact on financial market and economic growth with the help of macroeconomic variables in the economy. Hence, the financial sector reforms to revive the capital markets helped to attract the capital flows due to comparative returns. The second generation reforms now need to be tailored to further enhance the capital flow by opening up the insurance sector, allowing the pension funds to invest in equities, and mutual funds to invest in global financial market. The objective of this study is to observe and analyze the dynamics of some selected macroeconomic indicators in relation to the inflows of private foreign capital as a consequence of economic reforms in India and impact of capital flows on economic growth in India. The study also examines the trends and composition of capital flows into India.

2. OBJECTIVES OF THE STUDY

- To examine the impact of capital inflows on economic growth in India.
- To explore short and long run relationship foreign capital inflows(FDI)
- and its macro economics variables such an exchange rate, inflation, GDP and export in India**.**
- To investigate determines of foreign direct investment in India

3. RESEARCH DESIGN

NATURE AND SOURCES OF DATA

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The data for the study have been collected from the secondary source such as Handbookof Statistics in Indian Economy (RBI) and International Financial Statistics (IFS), (IMF).The monthly data have been taken for the period from April 1995 to Dec. 2006. The data of the study are private foreign capital inflows (FINV), Foreign Direct Investment (FDI),Foreign Portfolio Investment (FPI), Foreign Institutional Investment (FII) money supplyM3), exchange rate (EXR), wholesale price Index (WPI), export (EXP), import (IMP),foreign exchange reserve (FOREX), rate of interest (RI) and index of industrial production (IIP). The index of industrial production (IIP) has taken as the proxy of GDP, though my study is based on monthly time series data, the monthly data of GDP is not available. The choice of IIP as a proxy for economic growth is for two other reason. First, IIP is significantly correlated with real GDP (0.97 with a significance level of 0.01) aswell as with the real output of the services as a robust proxy for economic growth. Second, IIP is found to be reliable leading indicator of business cycles in India (Mazumdar, 2005). The period of study is constrained due to the unavailability of data after the liberalization period from 1991. So, the period of the study has been taken from April 1995 to December 2006.

4. METHODOLOGY

The methodology have employed in this paper such as ordinary least square method(OLS) to examine the impact of private foreign capital inflow on economic growth. Co integration test has used to find the presence of long run relationship between the variables. The Granger Causality test used to look the unidirectional and bi-directional relationship among the variable.

5. REVIEW OF LITERATURE

Kohli (2003) examines how capital flows affect a range of economic variables such as exchange rates, interest rates of foreign exchange reserves, domestic monetary condition and financial system in India during the period 1986 to 2001. She has examine show capital inflows induce real exchange rate appreciation, stock market and real estate boom, real accumulation and monetary expansion as well as effects on production and consumption. She investigates the impact on capital flows upon the domestic financial sector in India. Inflows of foreign capital have a significant impact on domestic money supply and stock market growth, liquidity and volatility. At the conclusion, the domestic financial sector that is the banking sector and capital market in the event of a heavy in flow of foreign capital in India. Correlation between domestic and foreign financial Market highlights India’s vulnerability to external financial shocks. For India on the relationship between portfolio flows and some stock market indicators suggest that market price are not unaffected by capital inflows. So far the difference between net capital inflows and current account deficit has been positive in India.

Chakraborty (2001) explain the effects of inflows of private foreign capital on some major macroeconomic variables in India using quarterly data for the period 1993-99. She analyses of trends in private foreign capital inflows and some other variables indicate instability. She has taken the net inflows of private foreign capital as well as macroeconomic variables foreign currency assets, wholesale price index, money supply, real and nominal effective exchange rates and exports. The Co integration test confirms the presence of long-run equilibrium relationships between a few pairs of variables. Butthe dependence of each variable on private capital flows invalidates such co-integration except in two cases co-integration exists between foreign currency assets and moneysupply and between nominal effective exchange rate and exports, even after controllingfor private capital flows. The Granger Causality Test shows

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unidirectional causality from private capital flows to nominal effective exchange rates- both trade-based and export based-,which raises concern about the RBI strategy in the foreign exchange market.Finally, instability in the trend of foreign currency assets could be partially explained by the instability in private capital flows with some lagged effect.

Lensik et al (1999) examine the impact of uncertain capital flows on the growth of 60developing countries during the 1990's. They distinguished between total capital flows, official capital flows and private capital flows. For the three types of capital flows, they derived a yearly uncertainty measure. They have used the yearly uncertainty measures in Ordinary Least Square (OLS) as we as Generalized Method of Moments (GMM) estimates, to explain the impact of uncertain capital flows on growth. They conclude that both types of estimates suggest that uncertain capital flows have a negative effect on financial market and growth in developing countries.

Rangrajan (2000) investigates the capital flows and its impact on the capital formation and economic growth taking into the variable as net private capital flows, net direct investment, net official flows, net portfolio investment and other net investments in22countries during 1992 to 2000. If capital inflows were volatile or temporary, the country would have to go through an adjustment process in both the real and financial market**.** Inflows, which take the form of direct foreign investment, are generally considered more permanent in character. Capital flows can be promoted purely by external factors which may tend to be less sustainable than those induced by domestic factors. Both capital inflows and outflows when they are large and sudden have important implication for economies. When capital inflows are large, they can lead to an appreciation of real exchange rate. He concludes that the capital account liberalization isn't a discrete event.Khanna (2002).

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