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Financial Market Integration and Capital Flows in India: A Discerning Trend

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Abstract

The spectacular surge in international capital flows in the world economy in the 1990s has been one of the most important developments that follow in tandem with the process of globalisation. These flows (both inflows and outflow) emanated from a greater financial liberalisation, improvement in information technology, emergence and proliferation of institutional investors, such as, mutual and pension funds, and a spate of financial innovations. There was increasing recognition that gains from international portfolio diversification, *albeit* less than that accrued from international trade, could still be significant. A number of studies have confirmed that financial globalisation can contribute significantly to promoting growth in developing countries by augmenting domestic savings, reducing cost of capital, transferring technology, developing domestic financial sector and fostering human capital formation.

At the same time, however, it has been recognised that sudden and large surges in capital flows cause several concerns. Large capital flows could push up monetary aggregates, cause inflationary pressures, destabilise exchange rates, exacerbate the current account position, adversely affect the domestic financial sector, and disrupt domestic growth trajectories. Volatility of capital flows, particularly portfolio flows and their consequent impact on the emerging market economies has been well documented in recent literature including that of multilateral institutions. With the increase in capital flows and participation of foreign investors and institutions in the financial markets of developing countries, the capital account has been the focus of attention since the late 1980s and especially so in the 1990s. It is noteworthy that the expansion of capital flows has been much larger than that of international trade flows. The process has been reinforced by the ongoing abolition of impediments and capital controls and the widespread liberalisation of financial markets in developing countries during the 1990s.

India’s experience with private capital flows has been somewhat recent. Traditionally, external aid was the major component of the capital account of India’s balance of payments. In recent years, however, the dependence on aid has been nearly eliminated. The capital account has been dominated by flows in the form of foreign direct investment (FDI), portfolio investments including ADR/GDR issues, external commercial borrowings, non-resident deposits and special deposit schemes such as India Development Bonds (IDBs), Resurgent India Bonds (RIBs) and India Millennium Deposits (IMDs). Indeed, the change in the size and composition of the capital account has played a significant role in the growing strength of the external sector of the Indian economy. With the setting up of roadmap for capital account liberalization in India (Report of the Committee on Fuller Capital Account Convertibility, 2006) and the policy measures undertaken since the early 1990s contributes to India's trade and finance flows which have grown in tandem with other emerging market economies of South East Asia including China.

Against this background of the global financial developments in the 1990s, the proposed paper would highlight the trends and compositional shifts in capital flows in respect of the Indian economy and traces their major determinants as well as their implications for growth and monetary management. A discussion of the trends in capital flows in India relating to broad policy objectives having focus on specific components of capital flows: foreign direct investment, portfolio investment, external commercial borrowings, non-resident deposits and external aid would be the major focus. Theoretical underpinnings as well as the cross-country experiences would be provided. A section on Indian experience with monetary management in the context of capital flows would also be discussed. Emerging issues relating to capital flows incorporating growth would also be discussed.