Financial Institutions and Markets
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Lecture – 60
Foreign Exchange Market – V

So, in the last class we discussed about the how the central bank intervention to the Foreign Exchange Market and shorten issues related to the capital convertibility and the foreign exchange reserve management. So, today we will be discussing about certain issues related to the foreign capital.

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So, whenever we talk about the foreign capital, why we need the foreign capital? There are many advantages, there are many disadvantages we have always whenever we discuss about foreign capital. But if you see in a larger point of view, foreign capitals are very important from the domestic growth point of view or economic growth point of view. Why? Because it relaxes the domestic savings constant, we may not have enough money for investment in the economic system because we need savings for the investment always we cannot say that investment crates the savings. But if you believe that the saving is a factor which is affecting investment, then there are sometimes we have enough investment opportunity.Bbut savings are not enough to fulfill that particular gap, then we need some foreign capital in the domestic market for the investment.

It also helps to overcome the foreign exchange barriers. So, there are certain kind of always we observe that, in the current account part there are some kind of deficit always we observe. So, the current account deficit can be fulfilled through the capital account surplus. So, how many inflow how much outflow in terms of capital account we will have that particular deficit whenever we observe in a particular account. The other account can be used for compensation or to make this particular thing balanced.

Through this foreign capital, we can access to the better technology for the foreign country. We can also attract the superior managerial skills, then also we can also occupy the bigger markets. We can create the demand for our commodities in the bigger markets. So, that is why the foreign capital is very important because through that we can also access to the better technology which is again helpful for the domestic market for the productions.

It also provides the risk sharing capital financing it is one of the sources through which the companies can use it for financing their investments. Foreign capital is another sources of financing for the investment of the domestic country. So, any kind of foreign capital which is used in the Indian market that also can be used for the foreign capital or as a source of financing for the companies. Basically it also fulfills the requirement for the; because you see every time the fund may not be adequate enough to utilize the full capacity of the particular companies.

So, the funds which are required for the full capacity utilization, that requirement always we can fulfill by taking the money from the foreign in the form of the foreign capital. So, that is why it is also needed for the full utilization of the existing production capacity of the home country. And it increases the competition in the market and also increases the efficiency.

Because we are getting better technology, if you are getting better technology then the productivity and the efficiency may increase for the domestic countries production process number 1. And because the other companies can enter in to the market further investments with a better technology or better facilities, then it will also always increase the competition.

And that competition sometimes also helps this Indian companies or other domestic companies to perform better in the economic system. So, this is the way the foreign capitals are quite important for any country, if you think from the domestic companies point of view.

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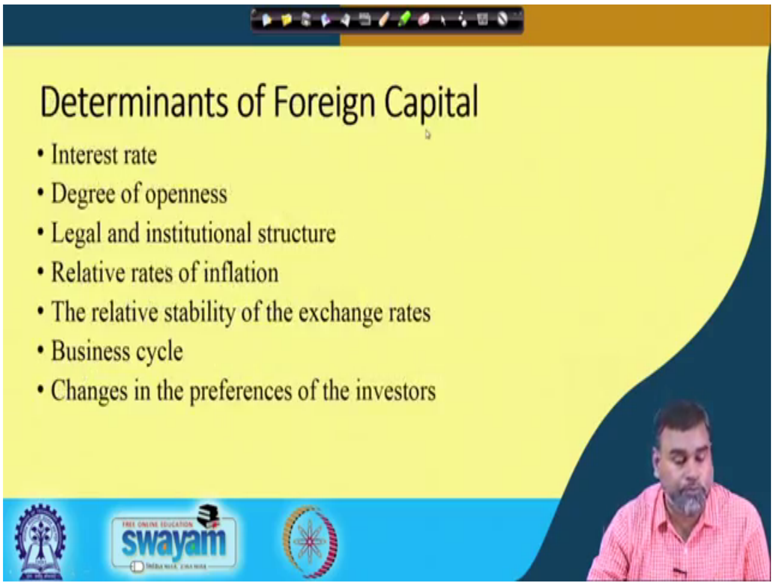

What motivates, what are the determinants of the foreign capital in aggregate? Obviously, the first one is interest rate, if the interest rate is higher in a domestic country the companies will be ready to borrow the money from their home country at a lower rate and invest that particular money in the domestic market or for them it is a foreign market at a higher rate.

So; obviously, it will be profitable for although the relatively the risk level is higher, but still sometimes the real rate of return what they are going to extract from this because there is always enough of investment opportunity or growth opportunity exist in the emerging economies or any kind of economies which are not that way matured enough in terms of the economic growth.

So, any if the interest rate is higher, this attracts the foreign investors to come to that country because that can take the advantage of the return of that particular market because they want to borrow these things at a lower rate and can invest it in a higher rate in the domestic economy in that particular point of time.

Degree of openness: degree of openness in the sense if the market is more open, then more company will be coming to India or coming to any domestic market.The reason is it will be hassle free, the cost of the investment in that particular market will be less and it attracts the basically more foreign investors to come to the domestic market for their investment.

Second thing is a next thing is you have the legal and institutional structure. The institutional structure or the infrastructure facilities should be adequate enough to create that kind of ambience for the investment in that particular economy. And that the legal structure should not be so stringent to get their license and all these things to start their business in the home country or to make their investment in that home country.

So, the legal and institutional structures both are conducive for the foreign investors to make their investment, to make their business in the home country. So, because of that it will attract more people or more companies to come to a domestic market around the another market for their investment. And another one is the relative rates of inflation. If inflation rate purchasing power of that particular company or particular country people is less, in a particular foreign country so, then what is happening that the value of the commodities in that particular market will be less, but the value of the commodities in another market may be more. The purchasing power of the money can be better utilized by investing that particular product in a particular country where there is a price stability or the companies can get advantage of can take the advantage in terms of the larger production at a lower cost.

Then stability of the exchange rate, if one country is if you see the currency with respect to another currency the conversion; if it is highly volatile, then it is not good for the country or good for the other companies come and invest in another country, but more or less if it is stable then they prefer to come to another country because they know that how much assets and liabilities they will have in the futures.

But even if there is some kind of fluctuations, some of the investors are there who are relatively risky in nature or they always are not that much risk averse. They can get that particular benefit out of this because if the fluctuations is always in their way which is favoring to their particular value of the trade. Then they always prefer to invest in that particular market to get that particular advantage.

Then with the business cyclic conditions because cyclic conditions in the economy may not be same across the countries, in one country may be in the recession another country is in the boom. So, if there is a boom in one country, then may be that particular point of time they can take the advantage by investing in that particular market because the market is doing well people have lot of power to purchasing power, then they can put their money in that particular products. So, because of that they can invest in that particular market at that particular of time.

Then another one thing is in today's world always we look at the consumer prospective. The consumers preferences are changing over the years, people are going for the multiple brands. They want the products produced by the multinationals, their behavioral perception towards that particular products are different.

So, to take the advantage or to cater that demand, we also need the foreign capital or the investments by the foreign entities are very much required for that because the preferences of the investors is going towards that directions. A preferences of consumers also going towards that directions.

So, the investor wants to always extract the return where ever there is a opportunity and consumer also wants the product from where they want to buy that or particular product or they want to maximize their utility by using that particular product. So, these are major factors which are affecting the flow of the foreign capital to a particular country.

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If you talk about India, we have the different components of the foreign capital. What are those components? We have a debt component, we have ECBs External Commercial Borrowings, we have a major component always we take the loans from IMF, we have a position in the IMF we can take the loan from IMF, we have NRI deposits, we have then we have foreign direct investments and foreign institutional investments.

So, NRIs have the different ways, different routes are there they can send their money to India and they can deposit their money India because they want to get the return out of this or some kind of interest out of this. We need money from IMF because of some kind of infrastructural development within the country. External commercial borrowings is related to the companies because already we discuss that it is also a part of the sources of finances of the company.

Because if the company needs any kind of funds excess funds may be the availability of the domestic funds which are there that may not be sufficient enough to cater the demand for investments of that particular country. They can take the help of the external commercial borrowings and the country can also take the loans or kind of debt from other countries for some specific purpose.

So, those are the different components of the foreign capital. But whenever you refer the foreign capital with respect to another country, we mostly focus on more on FDI and FII. FDI means the Foreign Direct Investment and FII means the Foreign Institutional Investment. The other name of that thing is foreign portfolio investments, either it is FII or FDI what we coin the words interchangeably in the concept of India.

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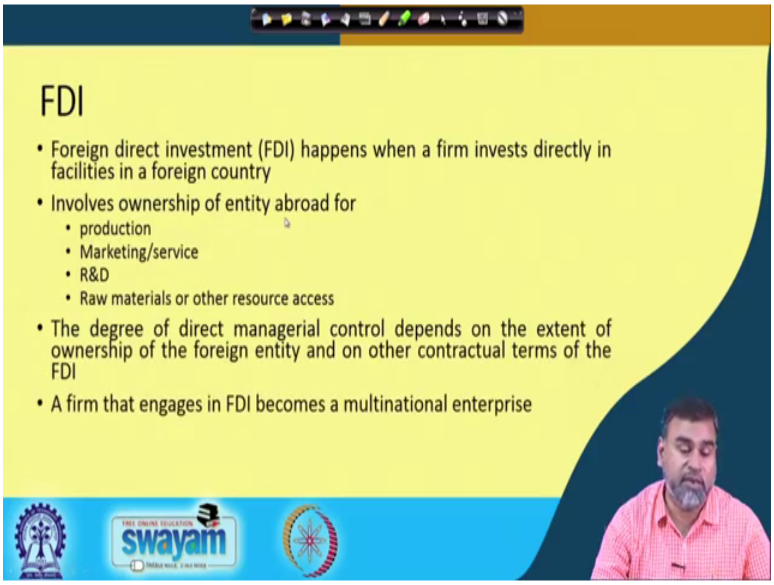

So, we will see that what exactly this FDI is and how it is basically available and how it is used in the market and what are the benefits and what are those disadvantages and as well as also we discuss something with respect to the FII. So, the foreign direct investment basically what it exactly means? The foreign direct investment basically happens when firm invest directly in the facilities in a foreign country.

They can have a different ways it is not confined to a particular area or particular domain; this can be for the specific various reasons. What are those reasons? It can be in terms of the production, they can participate in terms of the production process. They can also participate in terms of the marketing or services prospective.

They can also invest certain money in terms of R and D Resources and Development. They can also participate in terms of the raw materials providing the raw materials or other resources whichever are required for the that particular production of the commodities or the output for that particular country a particular company.

So, this is what different ways they can participate. It is not confined to that in one particular purpose the FDI is available. FDI is available in various reasons in the production process, in terms of the production, in terms of the marketing, in terms of the R and D Resources and Development. It can be in terms of the raw materials whatever. So, there are some kind of way they want to directly invest in another country.

So, the degree of managerial control depends on the extent of ownership in the foreign entity and on other contractual terms of the FDI. You see you can have a collaboration with another company you can take the example of Maruti Suzuki. So, you if you see those kind of examples, what kind of ownership we have? Further Suzuki has majority ownership or the Maruti has the majority ownership depending upon that the managerial control always works.

Though who ever whose ownership is more always the control of the manager for that particular company is always with that particular kind of country. So, a country which basically doing the foreign investments in another country, then they go by the rules and regulations of that particular country and accordingly the ownership will be decided in India we can have 49 percent, 51 percent, we have 71 percent, 29 percent. So, all the combinations are available, so any combination can work out. So, depending on that the managerial control with respect to that particular country will be there.

So, one firm may have the foreign direct investments in many countries, the ones they have involved in the foreign direct investment process that company becomes a multinational MNCs, that country sorry that company becomes a multinational company. Because they have the operations, they have the business across the globe or at least some of the countries are at least they are going beyond their national boundary. So, because of that those particular companies are defined as the multinational companies from our prospective.

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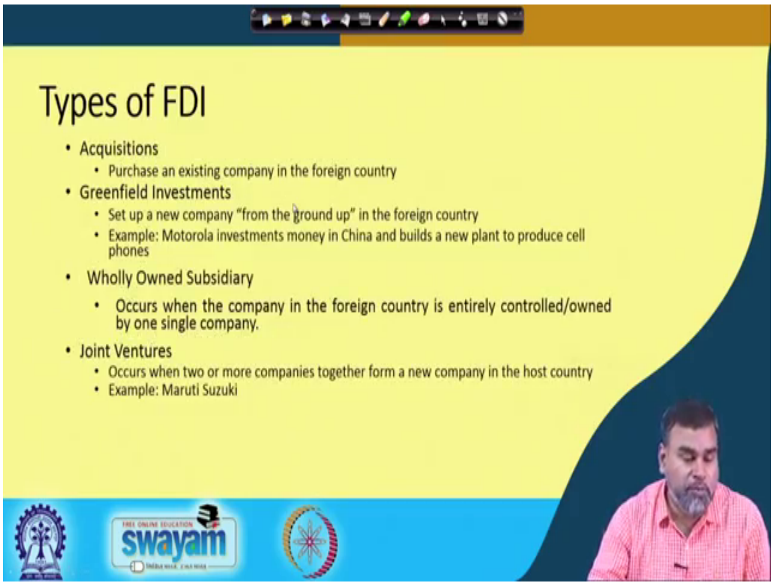

So, this is what basically FDI but if you see there are different types of FDI, different ways the FDI investments basically are made what are those ? For example, the FDI can be foreign direct investment can be made through accusations, one particular foreign company or one particular company can acquire another company in another country. They can purchase cross border acquisitions they can made always they can make.

So, if they will purchase an existing company in the foreign countries we call it acquisitions through that they have invested in the foreign capital through that also we can say that, the capital has been flown in to that particular country this is one way. Second way we have the green field investments, what do you mean by the green field investments?

Here one foreign company, one company comes to another company and set up a new company completely a new company set up a new company from the ground in the foreign country. Let India has gone to establish a new company in USA, so then we can call it is a green field investments because the company was not existing before, but they have started this company in that particular country from the zero ground level.

So, example if you see the Motorola who was started a was investment some investments they have made in China and they have built a plant to produce the cell phones. The Motorola is a American company who has started a plant in china to produce the cell phone; that means, we can say they have set up a new business there at all which was not there before.

So, all those production and everything assembling and everything are taking place in China, then we can say that this is a green field investments whatever they have made in that particular foreign country. So, because of that that way also the foreign capital can come to a particular country.

It is it can also come in the form of the wholly owned subsidiary when it happens? It happens when a company in the foreign country is entirely controlled by one single company, you can take the example of like Coca Cola; Coca Colas parent company let in US and they have the hundred percent subsidiary which is available in India which is called the Coca Cola India.

So, they have a parent company, but again we have a company which is established in India which is called the coca cola India, that is the separate company which is operating in India, but their profit and everything is may be is accumulated and finally, one consolidated balance it may be prepared from the Coca Cola world point of view or aggregate point of view, but still it is a full subsidiary to the Coca Cola USA which is the parent company.

So, that is why that is another way of having the foreign direct investment in another country. Then we have another option is joint venture that already I have told you we have taken the example of Maruti Suzuki, it occurs when 2 or more companies together form a new company in the host country. Here our host country is India let Suzuki is in Japanese, then Maruti is in the India company they have established a new company formed a new company which is called the Maruti Suzuki.

So, in that context they are producing the cars, they are selling the cars and everything and that comes under the banner of the Maruti Suzuki which is the new company which is formed in the another host in the hosting country like indie. So, this is another way of making the foreign direct investments in a particular country.

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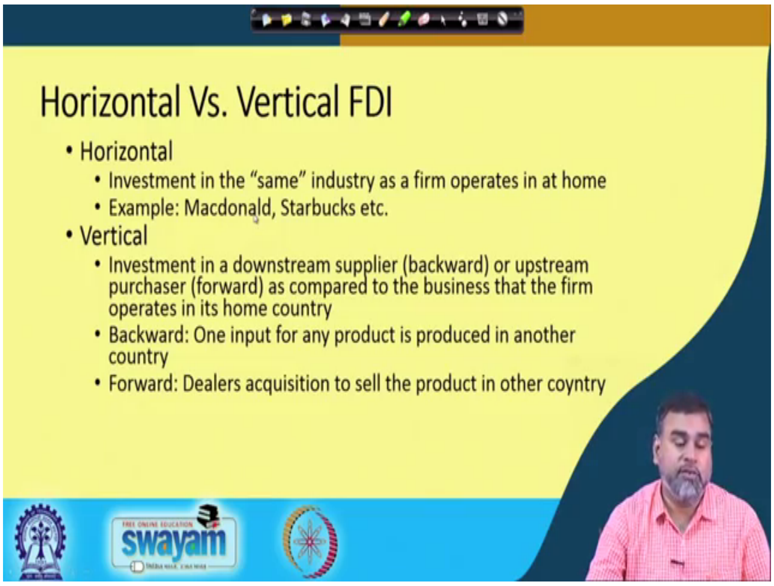

In the theoretical sense we have 2 types of FDI one is horizontal and another one is vertical. If you talk about horizontal; horizontal means investment in the same industry, as a firm operates in at home. Whatever business they are doing in US, the same business they are doing in India, same business they are doing in China, same business they are doing in Australia.

So, then what we can say there is a horizontal FDI horizontal investment they are making, you can take the example of Macdonald, Starbucks and all, who are basically have same type product they are selling across this globe. We have another kind of FDI which may happen that is called vertical FDI. Here the investment in a downstream supplier or a off stream purchaser as compared to the business that the firm operates in its home country.

I can take a example for example, somebody is producing a product let a car and to run the car they need the battery. But they find that producing the battery in that particular country is expensive for them, then what they can do? They can have kind of another company establish another company. They can have a joint venture to another company. In other country who is expertised in producing the battery and the battery will be produced in that particular country only for these cars.

So, the one input which is required for that particular final product, they can produce it another country for that a separate company will be there. They produce that product and sell it to that particular company which is exclusive made for that particular product for the, whatever final product the company is producing, so therefore, that is called the backward.

Forward means what here forwardvertical FDI what we call it, here basically what is happening you do not have to have any product, you can acquire the dealers to sell your is product in other country. Let if Audi wants to sell the car in US what they can do? The Audi is let Germany car then what they if they say they want to sell that product in USA or India.

They can totally acquire the dealer setup or marketing setup in India, by that through that they want to market or they want to sell their product in Indian context or Indian market. So, in that context we call it a forwarded vertical FDI which may happen with respect to that type of product. So, that is the way the horizontal vertical FDI are defined.

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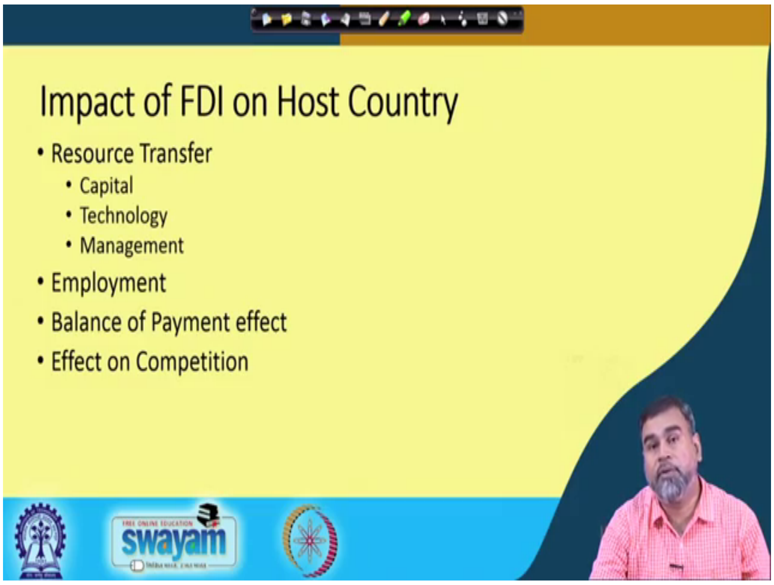

If you talk about the impact of FDI on hosting country, let India is the hosting country then some other countries are investing in India like US, Japan who ever whatever whoever the countries are investing in India. Then what kind of benefits the hosting country can have or what kind of impact it will have on the hosting country? First of all we have discussed it will have a resource transfer, they transfer it in terms of capital in terms of technology, in terms of management or managerial skill all kinds of things can happen.

It will increase the employment in the hosting country because new plants will be there new investments will be there, so because of that so more people in the hosting country can be employed. It will have a better balance of payment impact because already I told you; it will strengthen the capital account of the balance of payment.

The deficit whatever we have in the current account that can be compensated by the surplus in the capital account and it will also increase the competition. So, if the competition will increase then price will be competitive and if the price will be competitive then; obviously, it will have a positive impact on the overall price on that overall pricing of that particular product.

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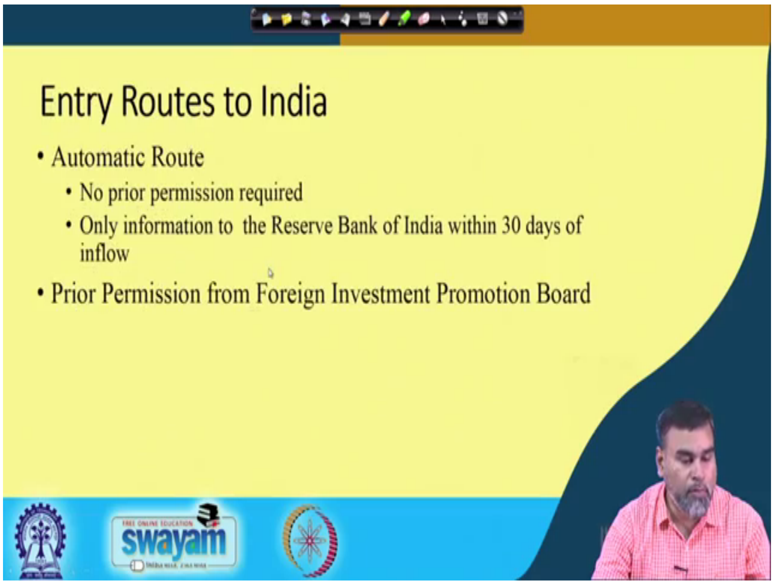

So, in India there are 2 roots through which the FDI can come, one is automatic root another one is the prior permission from the Foreign Investment Promotion Board FIPB, in short we call it. So, anybody wants to come to India for investments they can directly come no prior permission is required, but all those information to the reserve bank of India should be given with in this 30 days of inflow.

Whatever inflow they have made they have to give the information to reserve bank of India within these 30 days. And another thing is it is not through automatic root, there are some kind of regulations, some kind of constants, some kind of norms are there. So, they have to apply to FIPB for a Foreign Investment Promotion Board.

And foreign information foreign investment promotion board gives 4 to 6 weeks, to go through that documents whatever requirements we should have in terms of investments in India. Once they will by approve those kind of things and all those companies fulfill that requirements, they can come and invest in the Indian market. So, this is the way two routes, entry routes to Indian market.

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Then we have the foreign institutional investments, we have the foreign institutional investments basically what it is the made by the foreign investor in the shares of a company that is listed in the hosting country or in bonds offered by the hosting country ; that means, it's confined to the financial market mostly the FII investments are confined to the financial markets for FDI we have not confined to any kind of sector.

For example if a foreign investor buys the shares of Infosys, that qualifies as a FII investments for us for India. So, where the FIIs can invest, the FIIs can invest in securities in primary and secondary equity markets.

They can invest in mutual funds domestic mutual funds, they can invest in government securities, they can invest in the derivatives in the stock exchange and they can also invest in the commercial papers like that these are major investments which are allowed to FIIs or they can put their positions in the financial markets in terms of investments in these kind of assets. So, this is the way the instruments are chosen for FII investments in India.

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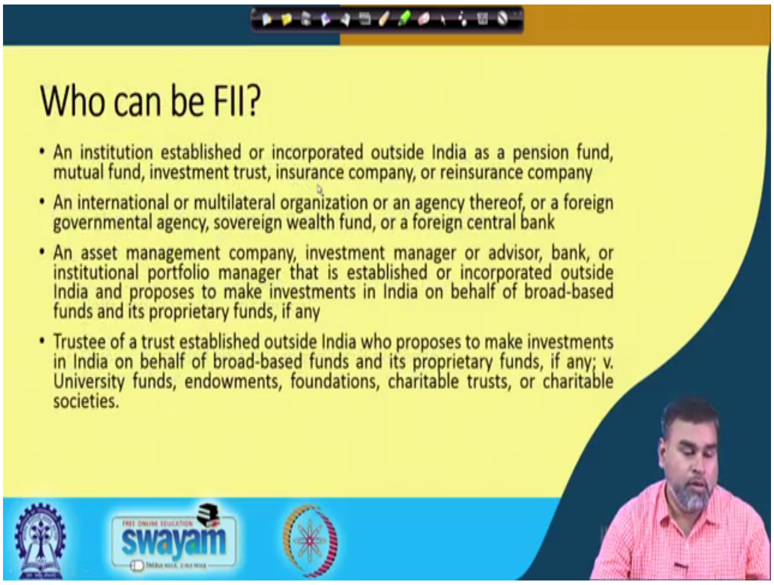

So, who can be the FII, to whom we can call FII or Foreign Institutional Investor? They can be this particular organization or institutions which is established or incorporated outside India. It can be a pension fund, it can be mutual fund, it can be investment trust, it can be insurance company, it can be reinsurance company anything any financial institutions who are doing the business outside India or established their setup outside India.Or it can be also a multi lateral organization, a foreign government agency, a sovereign wealth fund foreign central bank all everybody can be considered as the foreign investors..

It can be a asset management company, investment manager, bank, portfolio manager that is established or incorporated outside India and they want to make investments in India on behalf of the broad based fund and its proprietary fund if it is any.

The trustee or the trust which are established outside India, who wants to make investments in India on behalf of the broad based funds or its proprietary fund like the university fund, endowments, foundations, charitable trust, charitable societies. So, they all can be considered as the foreign investors if anybody wants to invest in the Indian markets, so they are basically categorized as the FII. This can be also any kind of bank or any kind of other companies who want to invest in the Indian market.

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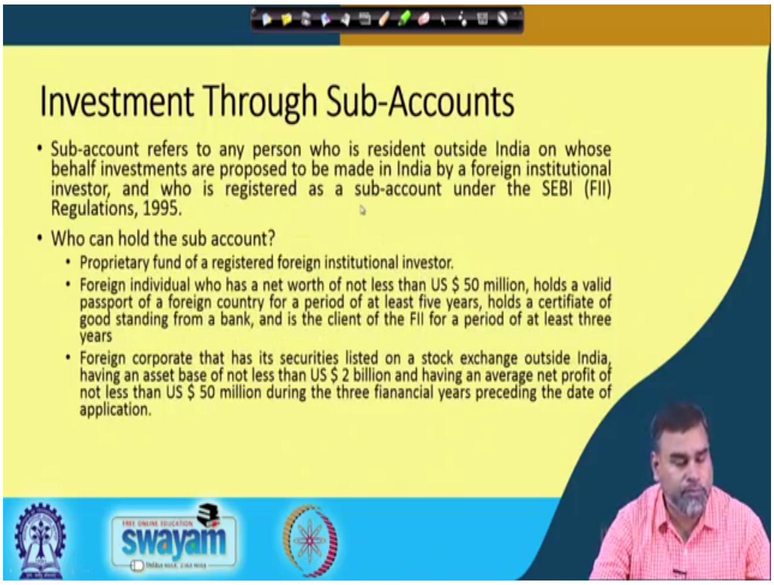

Another way of investment also there that is called the sub accounts. So, what do you mean by the subaccounts? Let any person who is a foreigner who is a resident outside India, but they want to invest in India. So how they do it because that is he is he or she is not an institutions he is an investor, he or she lives outside India or he or she citizen of other country, but they want to invest in India. So, how they do it? There is a provision called sub accounts.

So, here on whose behalf investments are proposed to be made in India by FII investor or foreign institutional investor who is registered as a sub account under the SEBI regulation nineteen 1995. So, they can invest through FII in the Indian market and through whom through FII who is already registered as a FII as per the SEBI regulation 1995.

Who can hold the sub account? It is the proprietary fund of a registered foreign institutional investor foreign individual who was has a net worth not less than 50 million US dollar, holds a valid passport of a foreign country for a period of at least five years, holds a certificate of good standing from bank. He should not be bankrupt or there should not be any kind of legal problems with respect to the financing has happened to that to that particular person.

And is the client of that particular FII for a period of at least three years on behalf of whom whose which FII is investing in India that person should be the client of that FII for at least three years. Foreign corporate it is for individuals foreign corporate, but they are not considered as FII, but that has its securities listed in the stock exchange outside India, having an asset base not less than 2 billion US dollar.

And having an average net profit of not less than 50 million US dollar during the three financial year preceding the date of the application. They are not FII considered as FII, but they can invest through another FII, but they should fulfill these conditions. Those are they can invest through this sub accounts.

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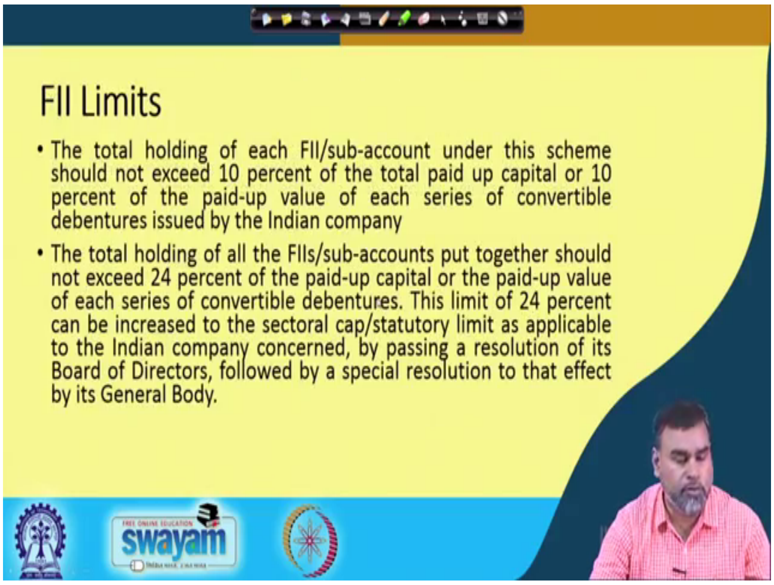

The limits how much they can invest, the total holding of each account holder under this scheme should not extend 10 percent of the total paid up capital each ; each foreign institutional investor cannot hold the 10 percent of the total paid up capital for that particular company, either it is equity or the debenture whatever it may be they cannot go beyond the 10 percent. And the total holding of all FIIs or sub accounts put together should not exceed 24 percent of the paid up capital and the paid up value of each series of convertible debentures.

The limit of 24 percent can be increased to the sectoral gap, it can increase to some extent with the special resolution by the general body. It can be first passed through the board of directors followed by the special resolution to that effect by its general body 24 percent in aggregate and each it should not exceed 10 percent.

But whenever we talk for example, any company anybody wants to any kind of foreign FIIs wants to invest in a company, if one individual FII can go maximum up to 10 percent of the total paid up capital, but in aggregate in that particular company the percentage of the FII should be 24 percent, but it can increase by the resolution of the general body or the board of directors.

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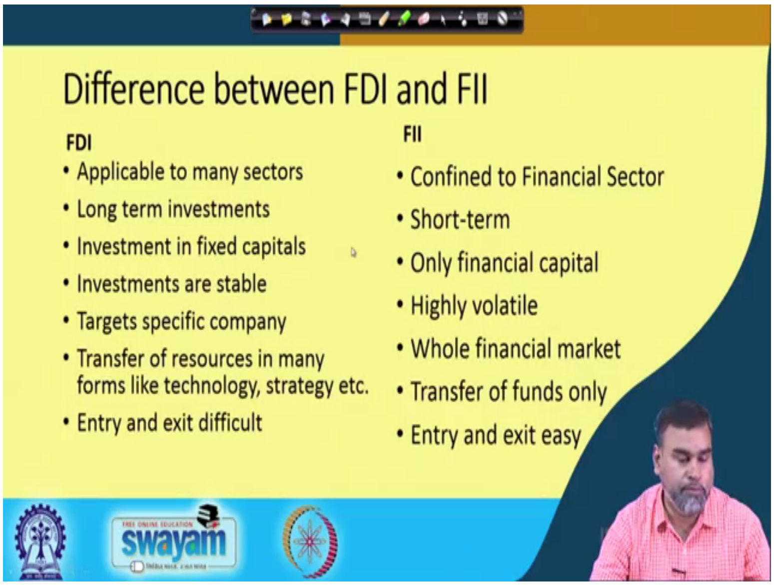

If say the differences FDI is applicable to many sectors, FII is confined to financial sector, FDI is for long term investment, FIIs for the short term investment, FDIs investment in fixed assets, FII is the only financial capital, investments are stable here it is highly volatile because the money invested in FII through FII is called the hot money. It targets the specific company, but here it targets the whole financial market.

Transfer of resources in many forms like technology, strategy and everything, here only money is transferred. Entry and exit is difficult if somebody or any company wanted as invested through FDI and entry and exit is easy in terms of FII any time they can go out of this investment or the market.

So, these are the major differences what we can observe and hosting country has control over FDI and in terms of FII we have not much control any time they can go out of the market.

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So, these are the references you can go through for the session and here you can have the, now you can you can have the broad idea about the financial system as a whole and as well as how the market functions, how the regulatory bodies functions, how the banks work and all these things and I hope you must have enjoyed all those topics whatever we have discussed in throughout this particular subject.

Thank you.