# UNIT 9 PORTFOLIO INVESTMENT

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## 9.0 OBJECTIVES

After going through this unit, you will be able to:

- explain the concept of Capital flows;
- distinguish between direct investment and portfolio investment;
- describe the world scenario of portfolio investmen; and
- bring out the relationship between portfolio investment and national income accounting.

## 9.1 INTRODUCTION

In a closed economy saving and investments are equal. This means the income generated gets distributed either between the consumption expenditures and investments, or consumption and saving. This automatically results in investment equalising to the savings. But a closed economy is a thing of the past. Now no economy can survive as closed economy. Rather there is an emphasis of opening up the economy to the extent that the domestic economy does not suffer. In other words, so long as it positively affect the growth of the GDP of an economy, the economy is integrated with the world economy.

With the opening up of the economy there is either a deficit or a surplus on the current account. It is rarely that there is an exact balance on the current account. In case of a surplus on the current account there is a deficit on capital account i.e. the country has sent more capital to the partner country or it accumulates the exchange reserves. Here, for the time being, we do not contemplate a

situation of a change in the exchange reserves. Then there is a shift in the capital. The reverse will happen when there is a deficit on the current account i.e. there will be a surplus on the capital account i.e. more capital will be coming in and less capital will go out.

Now when there is an excess of capital inflow i.e. more capital comes in, this could happen in three ways i.e. by way of raising debt, foreign direct investment and foreign portfolio investment.

## 9.2 MEANING AND DEFINITION OF CAPITAL FLOWS

### 9.2.1 Meaning of Capital Inflow

It is desired that first we understand the meaning and place of inflow of capital from abroad (i.e. foreign investment in a country) which will help us subsequently to understand the Portfolio Investment by the Foreign Institutional Investors (FII). For this, we start from a very simple example by considering a household. Now in case in a household you want to buy a TV, fridge or another gadget, you can buy it either from your own saving or by borrowing either from a bank, a relative or some financing company. Thus, if buying a household gadget by you is an investment, there are two ways of financing it, either by household own saving or by borrowing from outside.

In the same way, in an economy, total investment in a year, can be financed either by generating domestic saving or borrowing from abroad. In technical term it is called "inflow of capital from abroad". We can also put total investment in a year in an economy as follows:

$$TCF = DS + ICA$$

where TCF is Total Capital Formation (or investment), DS is Domestic Saving and ICA is inflow of capital from abroad.

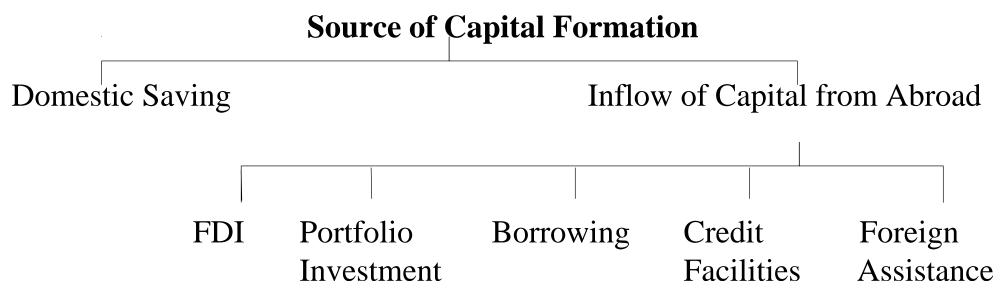
In the present lesson we will not go in details of the domestic savings. Therefore, we split-up inflow of capital from abroad.

### 9.2.2 Forms of Foreign Capital Flows

Capital flow from abroad or foreign capital may flow in an economy by various ways. Some of the important forms of foreign capital inflows are:

- Foreign Assistance
- Borrowing
  - i) Long-term borrowing
  - ii) Short-term borrowing
  - iii) Trade Credit facilities
- Investments
  - i) Portfolio Investment
  - ii) Foreign Direct Investment
  - iii) GDR

This is depicted in a diagram below:




Of these forms of inflows present lesson is concerned with the Portfolio Investment only.

## 9.3 FDI VERSUS PORTFOLIO INVESTMENT

Of the two types of investments, direct and portfolio, the former is better than the latter. In the case of FDI at least it brings with it the new technology. The local production and over the period there is a transfer of technology, how slow it may be. On the other hand foreign portfolio investment (FPI) is devoid of this virtue, at least over a short to medium terms of investments. In the free play foreign investor through FPI may acquire the management rights in the local units and exist whenever they like. There is no permanent stake in the case of portfolio holding.

The **capital account** is a record of the inward and outward investment and amortization flows between a country and the rest of the wold. The capital transactions recorded include those that result from the purchase or sale of real or financial assets.

Capital account transactions can be classified in one of two ways. The first way is to classify them as private or public transactions, that is, transactions made by private investors or by the government. The second way is to divide capital account transactions into **direct investment** or **portfolio investment**. Direct investment is a transaction in which the investor has a controlling share or participates in the management of the firm. Portfolio investment, on the other hand, is a transaction in which securities are held purely as a financial investment. It is often difficult to distinguish between direct investment and portfolio investment and, typically, the classification depends on the promotion of the firm held by the investor. The cut-of level of ownership beyond which an investment is classified as direct investment varies across countries but is usually around 10 per cent.

The accounting rule for capital transactions is based on the same logic as that used to record transactions in the current account. The sale of assets to foreigners and borrowing of funds abroad are transactions that are recorded with a positive sign because these transactions result in an inflow of international funds. Thus, a surplus in the capital account implies a decrease in the net holding of foreign assets by domestic residents. Analogously, the purchase of foreign assets is recorded with a negative sign.

**Check Your Progress 1**

1) Explain very briefly the meaning of capital inflow.

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2) What are the various forms of capital inflow flow abroad?

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3) State very briefly the distinction between the FDI and Portfolio Investment. Which one you would prefer and why?

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## 9.4 WORLD SCENARIO PORTFOLIO INVESTMENT

With the rapid progress of an economy, after a stage the rate of return on the capital declines. This happens owing to two reasons: (i) a decline in the demand expansion rate and (ii) as the capital base expands the total profits may rise but the rate of increase is likely to decline. This is the case with industrialised economy specially that of the United States and Western European countries. In view of this the capitalist in these countries look at the investment possibilities in those countries where the capital base is low and demand for goods and services is much higher.

The world scenario in respect of the portfolio investment over the past two decades has to be reviewed in this context.

Portfolio investment during the nineties has increased very rapidly all over the World. The progress is much better in the case of developing countries. In developing countries the increase in portfolio investment was from US$ 11 billion in 1992 to US$ 46 billion by 1996, a growth rate of 43 per cent per year.

However, India's share over the period, though has increased but is still lowest compared to Brazil, China, Indonesia, Malaysia and Thailand (Table 1).

**Table 1: Portfolio Equity Flows**

**(US$ million)**

| **Country** | **1992** | **1993** | **1994** | **1995** | **1996** |
|---|---|---|---|---|---|
| Brazil | 1734 | 5500 | 5082 | 4411 | 3981 |
| China | 1194 | 3818 | 3915 | 2807 | 3466 |
| India | 241 | 1840 | 4729 | 1517 | 4398 |
| Indonesia | 119 | 2452 | 3672 | 4873 | 3099 |
| Malaysia | 385 | 3700 | 1320 | 2299 | 4353 |
| Thailand | 4 | 3117 | 538 | 2154 | 1551 |
| Philippines | 333 | 1445 | 1407 | 1961 | 1333 |
| All Developing Countries (DCs) | 11000 | 45000 | 33000 | 32000 | 46000 |
| Share of India in LDCs (%) | 2.19 | 4.09 | 14.33 | 4.74 | 9.56 |

**Source:** *Global Development Finance*, (Vol. I & II). The World Bank.

There is evidence to show that India has managed to occupy a quasi – "top of mind" slot in the preceding years among foreign investors. The spate of newspaper articles and features in prominent newspapers, and articles demonstrate that India has been able to attract media attention. The impact of these developments will take some time to be felt. These include:

- Amendment of Foreign Exchange Regulation Act;
- Reduced list of industries requiring industrial licensing;
- Dilution of MRTP;
- Reduction in number of industries reserved for Public Sector;
- Liberalisation of imports and reduction in tariffs;
- Convertibility of rupee on Current Account;
- Opening up of the capital market to foreign investors.

Additionally, as part its initiatives to promote and protect investments, India became a member of Multilateral Investment Guarantee Agency. Bilateral investment promotion and protection agreements have also been signed with U.K., Russia, Germany, Malaysia, and Denmark. Several others are in the process of being finalised.

Liberalisation policy and procedural framework has in general been accompanied by revising of special policy-cum-incentive packages for key industrial sectors like telcom, hydrocarbons, tourism, drugs and pharmaceuticals, etc.

The subsequent restructured Foreign Investment Promotion Board (FIPB) and streamlining of procedures is another positive endeavour in the direction of augmenting foreign investment. A new Foreign Investment Promotion Council has been constituted to formulate policy guidelines and targets as also devise an approach for enlarging foreign investment into the country. The Council comprises of mainly professionals from the corporate sector.

Foreign Capital can flow into India either as FDI (Foreign Direct Investment) or as foreign investment in Indian securities.

Foreign investment in India securities flows in as:

a) Portfolio investment through purchase and sale of securities in Indian capital markets. The Indian capital market is partially open to investment by Foreign Institutional Investors (FIIs) within the prescribed limits. Disinvestment and dividends declared by FIIs are fully repartriable.

b) Investment in Global Depository Receipts (GDRs) and Euro convertible issued by Indian companies in overseas markets.

Substantial reforms have been undertaken to facilitate foreign portfolio investment in the debt and equity market. The relaxations that have been permitted in FII investment are

1) An FII can hold upto 10% in the equity of any company.

2) FIIs can invest in unlisted companies and in debt securities without prior investment in equity.

3) With a view to increasing the flow of funds to the gifts market, the RBI recently allowed Foreign Institutional Investors, including proprietary funds, to invest in dated Government securities and set up dedicated debt funds.

4) FIIs, Non Resident Indians and overseas corporate bodies can collectively investment upto 30% in a single company

5) FIIs have been given in-principle approval to invest in treasury bills.

6) FIIs have been permitted to take forward covers on their currency exposures on debt instruments.

In general, surges in capital inflows hold the potential for raising investment and growth. The larger the role of structural and fiscal policy changes in attracting the inflows, the greater seems to be the favourable impact on growth. However, the benefits are accompanied by potentially destabilizing effects, including inflationary pressures, appreciating real exchange rates and widening current account deficits. Inefficiencies in the financial system show up as widespread banking defaults and stock market volatility. Most countries initially respond to the inflows by sterilization, which seems to prevent widening of the current account deficit and substantially increases international reserves. Countries that have benefitted most from foreign inflows seem to have tightened fiscal policy as a means of controlling inflation and avoiding a real appreciation, especially in the years immediately after the surge in inflows. However, lack of public support and the need to develop infrastructure make it difficult to sustain fiscal restraint.

**Check Your Progress 2**

1) What is the need for investment in a developing economy by capitalist from a developed economy?

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2) Why did India's share in world portfolio investment it change between 1992 and 1996.

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3) What steps have been initiated by India to attract Portfolio Investment?

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## 9.5 FLOW OF FOREIGN PORTFOLIO INVESTMENT

Continued liberalisation in developing countries and the need for portfolio diversification in developed countries will ensure that the long-term outlook for sustained net inflows of private capital remains favourable. As the new investor base of institutional investors and pension funds expands, more of the private capital flows are likely to take the form of portfolio-especially equity flows.

In India, portfolio investment by Foreign Institutional Investors (FIIs) is wholly a post economic reform phenomenon. The comprehensive economic reform programme launched by the Indian government in 1991, encompassing financial sector deregulation as well as trade and industrial policy reform resulted in liberalisation of the financial markets and a substantial easing of restrictions on private capital inflows.

The initial surge of portfolio investment came in 1993-94, when FIIs were allowed to invest in securities in the Indian capital market. In the post-reform

period, FII inflows have increased from $4.3 million in 1993-93 to $2.4 billion in 1996-97, with the share of FII investment in total foreign capital inflow to India rising from 0.2% to 37.16% in the same period.

**Table 2**

| Year | Net Investment (US$ million) | % Change Over the Previous Year |
|---|---|---|
| 1992-93 | 4.3 | - |
| 1993-94 | 1634.1 | - |
| 1994-95 | 1528.3 | -6.5 |
| 1995-96 | 2035.6 | 33.2 |
| 1996-97 | 2432.1 | 19.5 |
| 1997-98 | 1649.4 | -32.2 |

**Source:** Government of India, Ministry of Finance, **Economic Survey 1997-98**, p. 60.

In 1998-99, the behaviour of share prices in India was affected by the trend in FII investment in other Asian capital markets. The turbulence in Asian financial markets affected overall FII investment in the region. In pursuance of the proposal made in the Union Budget for 1998-99, FII investing via 100 per cent debt route have been permitted to invest in unlisted securities. The procedure for granting such account registration in respect of registered FIIs has also been simplified. In order to facilitate investment by overseas investors, including NRIs, SEBI has created on overseas investment cell.

While FIIs continued to repose their confidence in the Indian securities market and its regulatory framework, their response to investment in the Indian market was affected by the reduction in their exposure to Asian markets.

The net FII investment (equity plus debt) declined by US$ 634 million or by about 6.8 per cent from US$ 9284 million in March 1997 to US$ 8650 million in December, 1998.

## 9.6 PORTFOLIO INVESTMENTS AND NATIONAL INCOME ACCOUNTING

The economic reform programme that included both fiscal adjustment and reform of the industrial and trade policy framework, played an important role in creating a favourable environment for FII investment. These reforms are briefly outlined here.

The fiscal deficit was brought down from 8.3% of GDP in 1990-91 to around 5.7% by 1992-93. The initial reduction in deficit (in 1991-92) was brought about due to a reduction in cash subsidies on exports and fertilizers and reduction in plan expenditures. But subsequently, the decline was achieved largely through cuts in public investment. In 1993-94, there was a temporary setback as fiscal deficit rose up to 7.4% of GDP due to a combination of lower realisation of receipts and higher expenditure. In 1994-95 and 1995-96 increased revenue

receipts (as a result of tax reform) and PSU disinvestment proceeds helped in the fiscal correction process. A better measure of fiscal consolidation is the primary deficit, which has improved from 4.3% in 1990-91 to 1.1% in 1996-97. The budgetary deficit (as a % of GDP) has also declined continuously in this period.

In the per-reform period, the Indian Financial System was driven by the development motives set for it, and it operated under a policy of controlled interest rates, directed credit to the priority or weaker sectors, excessive Government per-emption of savings and over-regulation of the capital market. Liberalisation of the capital market was initiated in 1991 with the introduction of free pricing of capital issues and the subsequent establishment of the Securities and Exchange Board of India (SEBI) as a capital market regulatory body. The capital market reforms agenda included measures such as the modification of the traditional carry-forward system, introduction of capital adequacy norms for brokers, improving settlement practices and transparency in trading and minimisation of insider trading the price rigging. The computerisation of existing stock exchanges and the creation of the countrywide screen based network of the National stock exchange have further improved the quality increase of trading in the country.

The money market matches short term cash surpluses and deficits of banking and non-banking institutions and the corporate sector through the call money market, intercorporate deposits, commercial paper, certificates of deposits and treasury bills. A wide variety of instruments have appeared in this market and greater access has been provided to non-bank participants. Secondary market liquidity has improved with the introduction of primary dealers and the setting up of the Discount and Finance House of India.

The initiation of bank reforms in 1992 has improved capital adequacy among nationalised banks and resulted in the adoption of prudential accounting norms in line with international standards. Further, the RBI permitted the re-establishment of banks in the private sector in 1992, which has brought in welcome competition with respect to customer service and technological upgradation. Para-banking services are provided by a large network of non-banking finance companies that operate both in the public and the private sector. Deregulation of interest rates has led to greater competition and finer pricing among banks and development finance institutions. In 1992, private sector participation was allowed in the mutual fund industry and by end-1996, there were around 20 private sector funds in the country, many with foreign collaboration.

In order to ensure that the gains from the devaluation of the rupee in 1990-91 were not “dissipated in inflation”, the monetary policy was simultaneously tightened. The main concern of the RBI in the period 1990-91 to 1992-93 was inflation control and this was achieved by hiking key interest rates in the economy, including the bank rate, prime lending rate and the deposit rate. In October 1991, the nominal prime lending rate was as high as 20%. Thus, from 1990-91, when the economic reforms programme was initiated, to 1993-94, when the first surge in foreign inflows took place, interest rates in India were much higher than that in overseas markets. The return on the RBI all shares index also rose in that period, providing attractive investment opportunities in equity. As interest rates rose due to tight monetary policy and administered

increases, the interest rate differential between India and the USA was as high as 12.8% in 1992.

Interest rate differentials between domestic and foreign interest rates would, however, need to be adjusted for expected depreciation appreciation of the Rs./$ exchange rate in order to satisfy the interest rate parity condition across economies. That is, the interest rate differential must be large enough to compensate for the cost of the forward premium on the dollar. This has not generally been the case for India. In the long run, expectations of a weak rupee may erode the attractiveness of investment in India notwithstanding the higher interest rates prevailing here.

In industrial policy reform, the Government has focused on industrial delicensing and dismantling of controls, thus reducing entry barriers for the private sector in areas previously reserved for the public sector. At the same time, in order to make domestic industry globally competitive, customs duties were gradually reduced and export incentives were increased.

Apart from interest rate differential we would attempt to look at the differentials in the returns on equity between India and the US and Europe as well as between India and the East Asian Markets. This would involve looking at return differential as well as the correlations between the returns in these markets with those on Indian stock markets. It is now accepted that emerging markets offer higher returns than developed markets, where market efficiency ensures that any potential profits are immediately wiped out through arbitrage. However, the importance of Indian stocks to international investors is based not so much on the higher returns bet on the low correlation between India's market index and foreign market indices. On the basis of data pertaining to a 17 year period, the average correlation between monthly returns on the S&P 500 index and the NSE-50 index is found to be -0.0198, which is lower than the correlation between OECD countries or other emerging markets and the USA. The low negative correlation implies that investment in Indian markets can be used to hedge investments in the US markets. Further, the high correlation between other indices in south-east Asia and the S&P index suggests that the cycles in the Indian stock market are completely different from those in south-east Asian economies, which further reinforces the significance of the Indian markets in international risk diversification, several new banks to be set up in the private sector. Private banks are expected to bring better customer services and innovative products to the banking sector.

The liberalisation of the capital market was initiated with the repeal of the Capital issues (Control) Act, which gave companies the freedom to price their capital issues in accordance with its fundamental worth and market perception. Simultaneously with the abolition of the office of the Controller of Capital Issues (CCI), the Securities and Exchange Board of India (SEBI) was armed with the statutory powers to regulate and reform the capital market and most primary and secondary market intermediaries were brought within its regulatory framework with the following measures:

- Abolition and subsequent modification of the manipulative and investor unfriendly carry forward or 'badla' system;
- Issuance of guidelines to minimise price rigging and insider trading;

- Improving the quality of disclosures in the prospectus;
- Reducing settlement periods and improving settlement practices;
- Indicating strict pricing norms for preferential issues to promoters;
- Increasing transparency in client-broker relationships by segregating client and broker accounts;
- Introducing capital adequacy norms for brokers; and
- Tightening entry norms for issuers of equity.

Mobilisation of resources in the primary capital market through equity grew phenomenally between 1990-91 and 1994-95, rising from Rs. 39.64 bn to Rs. 360.19 bn. The post CCI equity boom was sustained till 1994-95. In the period 1995-97, the depressed conditions in the equity market have resulted in increased mobilisation of funds through debt issues. The market capitalisation of shares on the Bombay Stock Exchange (which lists about 7000 scrips) has grown from Rs. 1102.79 bn in 1990-91 to Rs. 4710.39 bn in 1995-96.

In 1992, the Over The Counter Exchange of India (OTCEI) was set to promote resource mobilisation and trading in small capital companies. Established on the lines of the NASDAQ system in the USA, the OTCEI requires a minimum post issue capital of Rs. 30 lakh, as against Rs. 10 crore for the BSE. The OTCEI also trades in debt instruments and units of US - 64, which is one of the most popular schemes managed by the UTI.

In 1994, the National Stock Exchange commenced operations as a screen based, order driven trading system with a country wide network of members connected to the central computer in Mumbai through VSATs. By December 1996, the NSE network spanned 66 cities, out of which 49 have not stock exchanges. The transparent trading and widespread reach of the NSE have ensured that its trading volumes have been consistently higher than those of the BSE and market capitalisation has grown to Rs. 4200 bn (January 1997).

In 1994-95, the value of tradable debt outstanding was estimated at Rs. 3000 bn - comprising Rs. 2600 bn of bonds and Rs. 350 bn of money market instruments. In addition, there is an untraded debt market estimated at about Rs. 600 bn, including small savings instruments and company fixed deposits. Government bonds accounted for almost 80% of the outstanding debt in 1994-95. However, the slump in the equity market in the period 1995-97 has resulted in substantial debt issues by corporates both in the public and private sector, bringing down the share of Government debt to about 66% of the outstanding debt in March 1996. The setting up of the NSE marked the establishment of the first formal debt trading system in the country. The OTCEI also trades debt instruments, both of companies that are listed and not listed with it. However, trading in Government securities accounted for about 90% of the turnover of the debt segment of the NSE in 1995-96.

In order to integrate the corporate sector with the global markets, the finance ministry permitted Indian companies to make Euro issues of GDRs and Euro convertible bonds in 1991-92. In the period May 1992 to December 1996, Indian companies raised $6.70 bn through Euro issues out of which $5.43 bn (81%) was through GDRs and the remaining through convertible bonds.

In 1995, the BSE changed from its antiquated open-outcry trading system to the VSE Online Trading System (BOLTS), which facilitates electronic trading in the 6000 odd listed scripts. Seven other exchanges, including Delhi, Madras, Calcutta and Ahmedabad were computerised in 1996, and a few more are expected follow suit in 1997.

Trading systems were improved further with the setting up of the National Securities Depository Ltd. (NSDL) in November 1996 and the NSE commenced trading in dematerialised shares by the end of 1996.

The liberalisation of the economy and measured to encourage the inflow of foreign capital also included reform of the exchange rate regime. During the era of Bretton Woods System of fixed exchange rates, the rupee was pegged to the pound sterling at a fixed parity. A margin of 1 per cent on either side of the parity was allowed within which the RBI committed to buy and sell spot pound sterling against the rupee at fixed buying and selling rates. With the breakdown of the Bretton Woods System in 1971, and the consequent emergence of floating exchange rate system, the rupee was pegged to the US dollar for a short period (from August to December 1971), retaining the pound sterling as the intervention currency. With the realignment of currencies in December 1971, the rupee was delinked from the dollar and relinked to the pound sterling, at a fixed but adjustable parity with a wider margin of 2.25 per cent on either side (giving a band of 4.50 per cent), as was permitted by IMF to all member countries. When the pound sterling was floated freely in June 1972, uncertainties crowded the exchange rates of the rupee by putting server free market pressure and the rupee was to be revalued frequently in response to the continued depreciation of the pound sterling.

On September 25, 1975 the rupee was delinked from the pound sterling and linked to an undisclosed basket of currencies. This arrangement, which continued till February, 1992 retained the pound sterling as the intervention currency and the RBI established the daily rupee-sterling rate. The exchange rate against other currencies were determined on the basis of cross rates with the rupee-sterling rate and the exchange rate of sterling against the concerned currencies, based on the London closing rates. A five per cent margin in either side allowed RBI to make adjustments. The margin transformed the basket linked arrangement into a flexibly managed floating currency, in practice.

The system of basket linked management of exchange rates was withdrawn in March 1992 and the RBI stopped setting the external value of the rupee through the rupee-sterling rate. Partial convertibility of the rupee was introduced in the form of the Liberalised Exchange Rate Management System (LERMS). Under this system all forex receipts on current account transactions were required to be submitted to the Authorised dealers of foreign exchange in full, who in turn would surrender to RBI 40% of their purchases of foreign currencies at the official exchange rate announced by RBI. The balance 60% could be retained for sale in the free market. As the exchange rate aligned itself with market forces, the Rs/$ rate depreciated steadily from Rs/$ 25.83 in March 1992 to Rs/$ 32.65 in February 1993. The LERMS as a system in transition performed well in terms of creating the conditions for transferring an augmented volume of foreign exchange transactions onto the market. Consequently, in March 1993, India moved from the earlier dual exchange rate regime to a single market determined exchange rate system.

As the exchange rate became more market-determined, the foreign exchange markets also became more dynamic. For a long time the only hedging option available to Indian corporates was the foreword cover. The Indian market is illiquid beyond six months and forward contracts are ordinarily available only for a period of six months though there are no restrictions on ADs offering cover for longer periods. In August 1997, the RBI allowed ADs to provide forward covers to foreign institutional investors with respect to their investments in debt. This is expected to provide greater liquidity to the forward market and bring in more foreign investment in debt instruments.

In January 1994, banks allowed to offer cross currency options on a fully covered basis Corporates were allowed to cancel the option only once and they were not permitted to rebook options against the same exposure. However, the corporate could hedge the exposure using the forward market. In the absence of a rupee yield curve, banks are unable to price or offer rupee based currency options. Further, restrictions imposed on cancellation and rebooking and the high cost of upfront premium have ensured that these options have not become popular. Till recently, ADs were allowed to undertake rupee swap transactions subject to RBI approval, which was granted on a case-by-case basis. In the monetary policy announced on 15 April 1997, the RBI allowed corporates to undertake rupee forex swaps through ADs without prior permission from the RBI.

The forward market provides the conditions for the integration of the foreign exchange market with the money market, particularly the call money market. For instance, tight liquidity conditions in the money market and high call money rates may induce a demand for swaps where by banks acquire spot rupees to be swapped for forward dollars. This, in turn, would push the swap premia upwards. The recent abolition of reserve requirements on net interbank liabilities is expected to develop a rupee yield curve and enable better integration of the call money and forward rates.

In addition on the above measures steps are being taken to make the rupee fully convertible in the next few years by achieving capital account convertibility. Capital account convertibility refers to the freedom to convert local financial assets into foreign financial assets and vice versa, at market determined rates of exchange. Therefore, capital account convertibility implies the right to import or export capital without restrictions. As a part of the ongoing process of economic reforms, current account convertibility was established in August 1994. However, controls continued to operate on transfer of capital abroad by resident individuals as well as capital inflows and outflows by banks and institutional entities. In order to lay out the road map to capital account convertibility, a committee was appointed by the Reserve Bank of India under the Chairmanship of Mr. S. S. Tarapore, which submitted its report in May 1997. The Tarapore Committee has recommended that full convertibility of the rupee should be achieved in three phases by 1999-2000, and the process should be subject to the fulfillment of certain pre-conditions. The first phase of the implementation of convertibility commenced from the financial year 1997-98.

## 9.7 LET US SUM UP

This unit dealt with a topic that was at a slight tangent to the usual topics in national income accounting. Protfolio investment are investments made by

individuals and institutions which are in the form of financial securities. The unit discussed in detail the meaning and definitionof capital flows with special reference to India.

The unit carefully distinguished between portfolio and direct investments, the latter being addition to real capital. The unit discussed the flow of foreign portfolio investment, with special reference to India. The unit discussed the relationship between portfolio investment and national income accounting.

## 9.8 KEY WORDS

**Capital Account** : A record of the inward and outward investment and amortization flows between a country and the rest of the world.

**Direct Investment** : Investment where the investor has a controlling share or participates in the managing of the firm.

## 9.9 SOME USEFUL BOOKS

Agarwala, S.K., (1998), *National Income Accounting*, Bookland Publishers, Delhi

Dhingra, I.C. (2005), *Indian Economy*, Sultan Chand and Sons, Delhi.

Hicks, J.R., Mukherjee,M, and Chosh, S.K. (1984), *The Framework of the Indian Economy*, Oxford University Press, Delhi.

## 9.10 ANSWERS OR HINTS TO CHECK YOUR PROGRESS EXERCISES

**Check Your Progress 1**

1) See subsection 9.2.1

2) See subsection 9.2.2

3) See subsection 9.3

**Check Your Progress 2**

1) See subsection 9.4

2) See subsection 9.4

3) See subsection 9.4