Foreign Capital Flows and India's Balance of Payments

Source: IE

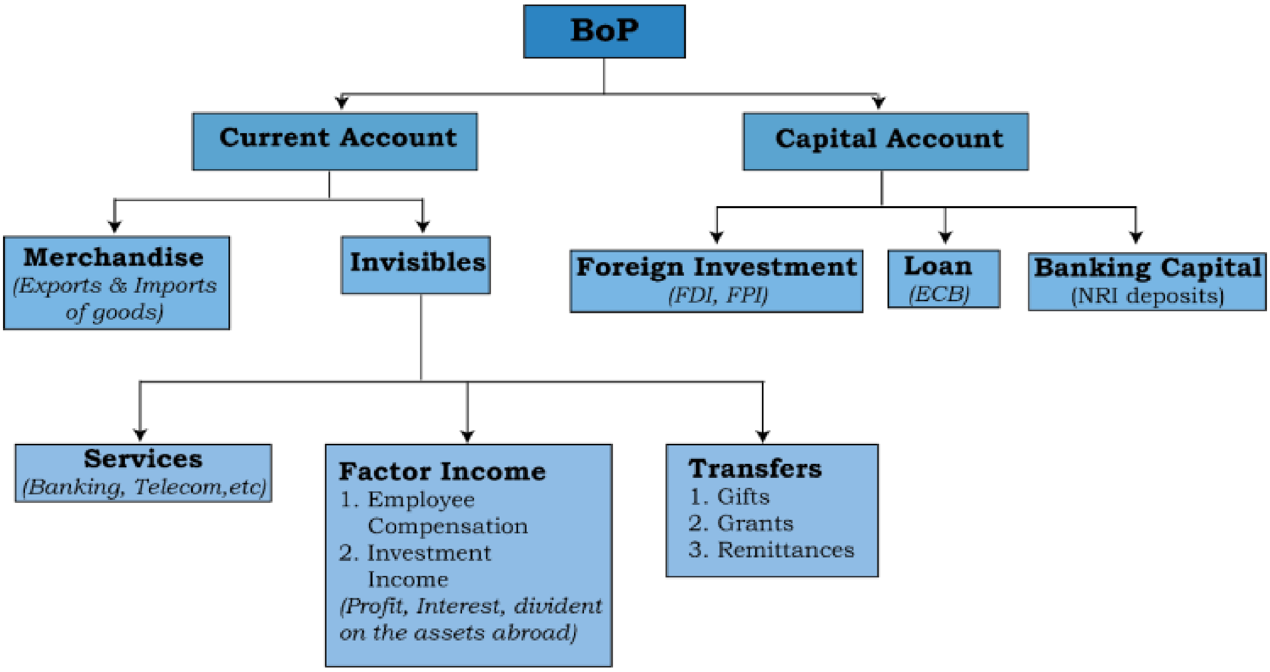
Why in News?

India has emerged as the **world's fastest-growing major economy,** recording an average annual GDP growth of **8.2% from 2021 to 2024**, outpacing countries like **Vietnam, China, and the United States.**

- **Despite strong growth, India faces low net foreign capital inflows, reflecting a gap between GDP expansion and investor sentiment in its Balance of Payments.**

What is Balance of Payments?

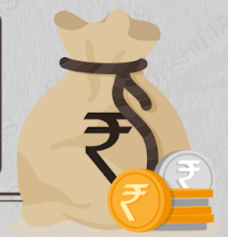
- **About:** The BoP serves as a crucial economic indicator, detailing all financial transactions between India and the rest of the world.
  - This comprehensive ledger **tracks the inflow and outflow of money where inflows are marked positive and outflows negative**, reflecting the country's economic interactions globally.
  - It measures the relative demand for the rupee against foreign currencies, crucially influencing exchange rates and economic stability.
- **Component of BoP:**
  - **Current Account:**
    - Trade of Goods: Tracks physical imports and exports, indicating the balance of trade. A deficit suggests higher imports than exports.
    - Trade of Services (Invisibles): Includes sectors like IT, tourism, and remittances, contributing positively to India's current account surplus despite trade deficits.
    - The net of these two components determines the current account balance.
  - **Capital Account:**
    - Captures investments such as Foreign Direct Investment (FDI) and Foreign Institutional Investments (FII), essential for economic growth and stability.
    - The capital account flow reflects factors such as commercial borrowings, banking, investments, loans, and capital.



What is the Current State of India's Balance of Payments (BoP)?

- **Trade Deficit and Invisibles Account**: India's **trade deficit continues** to widen, reaching **USD 287.2 billion in 2024-25.**
  - However, this has been offset by surpluses in the **"invisibles" account,** primarily due to **services exports and remittances from the Indian diaspora**.
  - These surpluses have helped maintain a manageable **Current Account Deficit (CAD)**, even as merchandise trade deficits balloon.
- **Growth & Investment Paradox**: Despite robust growth, India has faced challenges in attracting foreign investments. In the financial year 2023-24, **foreign portfolio investments (FPIs)** amounted to USD 25.3 billion.
  - However, India experienced **significant net outflows in previous years**, with USD 5.1 billion in 2022-23, USD 14.6 billion in 2024-25, and USD 2.9 billion in 2025-26 (as of September 5).
    - This trend highlights a paradox where India's economic expansion does not align with foreign capital influx.
- **Private Equity and Venture Capital Exits: The increase in exits from private equity (PE) and venture capital (VC) investments reflects profit-booking and matured investments, rather than new capital creation.**
  - The total value of PE/VC exits was **USD 24 billion** in **2022**, **USD 29 billion** in **2023**, and **USD 33 billion** in **2024**.
  - Foreign investors prioritize **corporate earnings**, the **overall business climate**, and **market valuations** over the headline **GDP growth** figures.

FDI and FPI



Foreign Direct Investment (FDI)

- **About:**
  - Investment made by foreign entities/individuals in businesses and assets located in a different country
- **FDI Routes:**
  - Automatic Route:
    - No prior government approval required
    - Up to 100% allowed in non-critical sectors
  - Government Approval:
    - Necessary in certain sectors or for investments above specific thresholds
    - Administered by Department for Promotion of Industry and Internal Trade (DPIIT) and RBI
- **Examples of Approval via Auto and Govt Route:**
  - Banking (Private sector): up to 49% (auto) + above 49% and up to 74% (Govt)
  - Defence: up to 74% (auto) + above 74% (Govt)
  - Healthcare (Brownfield): up to 74% (auto) + above 74% (Govt)
  - Telecom Services: up to 49% (auto) + above 49% (Govt)
- **Foreign Investment Promotion Board (FIPB):**
  - Comes under Ministry of Finance
  - Responsible for processing FDI proposals - facilitated by Foreign Investment Facilitation Portal (FIFP)
  - Making recommendations for Government approval

Govt's prior approval is mandatory for FDIs from countries sharing land border with India (China, Bangladesh, Pakistan, Bhutan, Nepal, Myanmar and Afghanistan)

- **India's Top 5 FDI Sources (FY 2022-23):**
  - Mauritius
  - Singapore
  - USA
  - Netherland
  - Japan
- **India's Top Sectors Attracting FDI (FY 2022-23):**
  - Services Sector
  - Computer Software & Hardware
  - Trading
  - Telecommunications
  - Automobile Industry

Foreign Portfolio Investment (FPI)

- **About:**
  - Investments made by foreign individuals, institutions, or funds in financial assets
  - Known as Fly by Night or Hot Money
- **Imp Features:**
  - Purchase of financial assets occur without gaining ownership
  - Passive investment approach
  - Investors earn returns through dividends, interest, and capital appreciation
- **Example:**
  - Stocks, Bonds etc.
- **Regulatory Body:**
  - Securities and Exchange Board of India (SEBI)

Difference between FDI and FPI

Features	FDI	FPI
Nature of Investment	Long-term	Short-term
Objective	Long-term presence in a foreign country	Earning quick returns on investments
Control	Significant (over the invested entity)	No or limited control
Investments in	Tangible assets (e.g., factories, buildings)	Financial assets (e.g., stocks, bonds)
Returns	Profits, Dividends, and Capital appreciation	Dividends, Interest, and Capital appreciation
Policy Regulations	Govt policies and sector -specific regulations	Flexible regulations and easier entry/exit
Impact on Economy	Job creation, technology transfer, and economic growth	Short-term liquidity and impact on stock market performance

Drishti IAS

Prelims PYQ

Q. With reference to investments, consider the following: **(2025)**

1. Bonds
2. Hedge Funds
3. Stocks
4. Venture Capital

How many of the above are treated as Alternative Investment Funds?

(a) Only one
(b) Only two
(c) Only three
(d) All the four