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TABLE OF CONTENTS

1. Learning Outcomes

After going through this Unit, you shall be able to:

- Know about the External resource flows
- Know about Debt creating flows and Non debt creating
- Know about FDI and its trends in the country, policy measures and recommendations;
- Know about FPI and its trends in the country;
- Learn about debt creating flows and types.

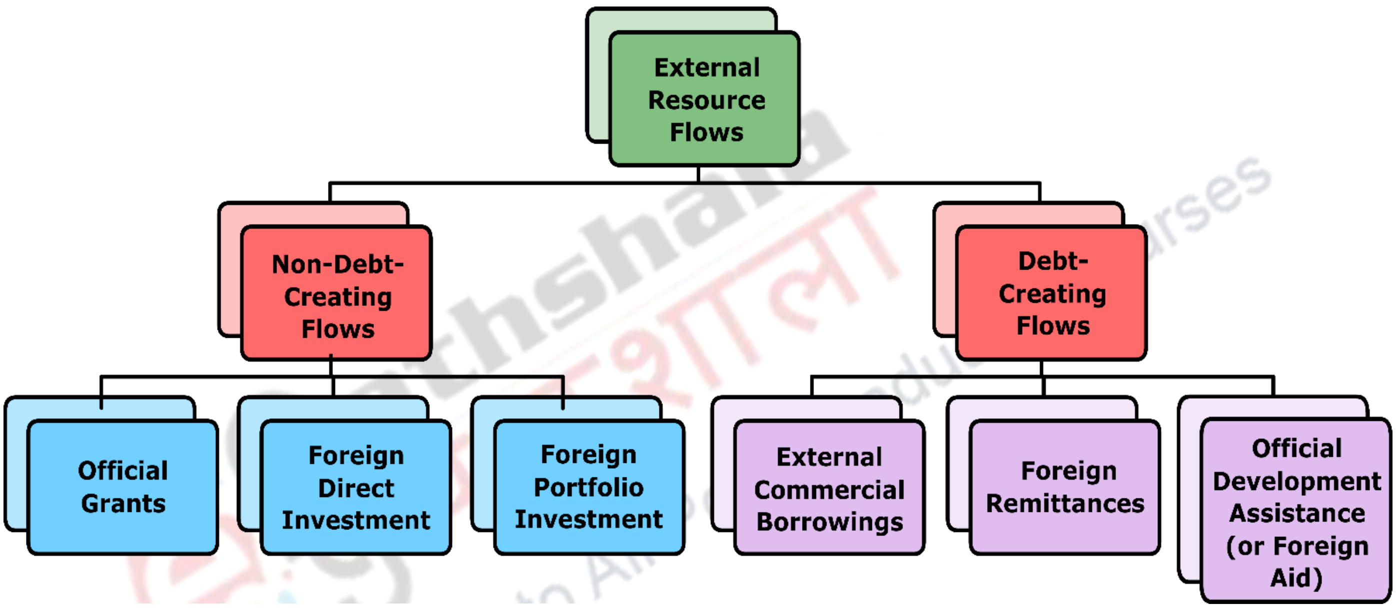
2. Introduction

In today's era, every economy is questing for excellence, and gearing towards progressive institutionalization that paves the way for economic growth and development. Economic growth and development are the imprints of the economic well-being and better standard of living. So, capital as the driver of economic development plays a very significant role. This module focuses on capital and how it is flowing globally. The module also focuses on trends of FDI and FPI in context of India.

We are in the age of globalization wherein all the economies are interlinked and interdependent. This has paved way for capital flowing across the globe. Majorly, developed economies invest in developing and emerging economies. This is because there is a strong relationship between foreign investment and economic growth. Larger inflows of foreign investments are needed for the country to achieve a sustainable high path of economic growth, as foreign capital can augments domestic savings as well as accelerate productive investments, promote financial deepening and risk diversification.

3. External Resource Flows

There are two types of external resource flows namely; Debt creating flows and non-debt creating flows, these are further bifurcated into foreign direct investment, foreign portfolio investment and external borrowings, foreign remittances and official development assistance (Foreign Aid) respectively.
The categories of external resource flows can be depicted as follows:



4. Non - Debt Creating Flows

Non-debt-creating Flows are net foreign direct investment, portfolio equity flows, and official grants (excluding technical cooperation). Net foreign direct investment and portfolio equity flows are treated as private source flows. Grants for technical cooperation are shown as a memorandum item.
It refers to the flow of financial resources in the form of Foreign Investment which do not involve any repayment obligation and hence do not create debt burden on the recipient country. These non-debt-creating flows mainly are of two types: Foreign Direct Investment (FDI), and Foreign Portfolio Investment (FPI).

4.1 FDI: Foreign Direct Investment

Foreign direct investment is the act of investing a certain capital in the chosen business enterprise that operates in foreign countries. FDI is usually a physical investment like building a factory, hotel, farms, or other businesses or an office. It usually includes a parent company, which in the effort of expanding establishes its office as a permanent company in a foreign country. FDI intends to '*control*' and '*participate in*' the management of a business enterprise. In this way the parent company gets the level of MNC and its investment is known as FDI for the host country. FDI involves foreign investors taking a controlling and lasting stake in productive enterprises. FDI is not just a transfer of ownership as it usually involves the transfer of factors complementary to capital, including management, technology and organisational skills. This is a major source of non-debt financial resource for the economic development.

4.1.1 Salient features of FDI

The following are important features of FDI:

(i) An investment made to acquire lasting interest in enterprises operating outside of the country of the investor;

(ii) The foreign entity that makes the investment is termed the '*direct investor'*;

(iii) The investor's purpose is to gain an effective voice in the management of the enterprise. Some degree of equity ownership is almost always considered to be associated with an effective voice in the management of an enterprise. *The IMF's Balance of Payments Manual: Fifth Edition (BPM5)* suggests a threshold of 10 per cent of equity ownership to qualify an investor as a foreign direct investor. An effective voice in management only implies that direct investors are able to influence the management of an enterprise and does not imply that they have absolute control;

(iv) In most instances, both the investor and the asset it manages abroad are business firms. In such cases, the investor is typically referred to as the '*parent firm*' and the asset as the '*affiliate*' or '*subsidiary*'; and

(v) Operationally, FDI flows may take following forms:

(a) *equity acquisition*--buying shares of an existing or a newly created enterprise,

(b) *profit re-investment*--FDI firms re-investing their profits for further expansion, and

(c) *Loans* from a parent company.

In addition to FDI, foreign investor has a number of routes for investment into India. These include:

(i) Investment in export trading companies,
(ii) NRI investments,
(iii) off-shore funds,
(iv) Euro issues,
(v) Foreign institutional investments, and
(vi) Venture capital investments.

4.1.2 Trends in FDI inflows to India:

Pre-1991: One of the most significant developments in the world economy in the 1990s has been the spectacular surge in international capital flows. It is noteworthy that the expansion of *capital flows* has been much larger than that of international trade flows. This section provides *trends in volume, patterns, and sources* of foreign investment in India.
Over the period before 1984, foreign investment continued to take place *albeit* at a slow pace despite severe restrictions even during periods of maximum controls.
The total assets of foreign subsidiaries increased by 144 per cent from Rs. 11,290 million in 1968-69 to Rs. 27,590 million in 1982-83 (at current prices). Their paid-up capital also increased by 72 per cent from Rs. 2,400 million to Rs. 4,120 million during this period. *After 1984*, however, the inflows of foreign capital in the form of equity remained quite low. In fact, the net inflows of foreign investment were mainly in the form of retained earnings that could be apportioned to the foreign equity holders. Between 1984 and 1990 actual fresh gross annual inflow of capital was just around Rs. 100 million in respect of foreign controlled domestic companies.

The *Table* below provides data and one can have a glance at that for numbers.

Table: Statement on Year-Wise/Route-Wise FDI Equity Inflows from January, 2000 to May, 2015

Amount in Rupees (US$) million

Calendar Year (January-December)	I Govt. approval Route (FIPB,SIA)	II Automatic Route	III Inflows through acquisition of existing shares Route	IV RBI's – Various NRI's Schemes ^	Cumulative total (I to IV)
2000	63,428 (1,475)	16,975 (394)	20,521 (477)	3,487 (81)	104,410 (2,428)
2001	96,386 (2,142)	32,411 (720)	29,622 (658)	2,292 (51)	160,711 (3,571)
2002	69,580 (1,450)	39,030 (813)	52,623 (1,096)	111 (2)	161,345 (3,361)
2003	42,957 (934)	23,400 (509)	29,284 (637)	-	95,640 (2,079)
2004	48,517 (1,055)	54,221 (1,179)	45,076 (980)	-	147,814 (3,213)
2005	49,672 (1,136)	68,743 (1,558)	74,292 (1,661)	-	192,707 (4,355)
2006	69,684 (1,534)	321,758 (7,121)	112,131 (2,465)	-	503,573 (11,119)
2007	107,873 (2,586)	361,002 (8,889)	186,075 (4,447)	-	654,950 (15,921)
2008	135,588 (3,210)	1,004,681 (23,651)	455,026 (10,234	-	1,595,295 (37,094)
2009	229,716 (4,680)	919,849 (19,056)	160,233 (3,309)	-	1,309,799 (27,044)
2010	115,966 (2,542)	655,519 (14,353)	188,664 (4,111)	-	960,150 (21,007)
2011	134,782 (2,933)	878,222 (19,053)	586,345 (12,636)		1,599,349 (34,621)
2012	159,557 (2,964)	845,289 (15,825)	211,069 (4,000)	-	1,215,914 (22,789)
2013	78,657 (1,345)	744,183 (12,806)	471,985 (7,887)		1,294,825 (22,038)

2014	109,979 (1,809)	1,226,012 (20,089)	417,143 (6,887)		1,753,134 (28,785)
2015 (up to May, 2015)	69,131 (1097)	938,684 (14,980)	79,006 (1262)		1,086,821 (17,339)
GRAND TOTAL ^ (as on 31.05.2015)	**1,581,473 (US$ 32,892)**	**8,129,979 (US$ 160,996)**	**3,119,095 (US$ 62,747)**	**5,890 (US$ 134)**	**12,836,437 (US$ 256,769)**

Source: RBI, (FED) Central Office, Mumbai
Note: '^'Since 2003, inflows included under the heading RBI's Automatic Route

In India there has been little FDI in the export sectors. Indian exports continue to remain based on Indian capital. FDI has largely taken place to access the Indian domestic market, as in automobiles. While analysing the recent trends in FDI flows in India *Ragavendra Jha* finds that FDI flows to India have not been commensurate with her economic potential and performance. The quality of FDI as manifest in technological spillovers, export performance etc. is more important than its quantity. The study conducted by *K.S. Chalapati Rao and Biswajit Dhar* has emphasised that there is a need to have a close look at the present phenomenon of FDI. India should build an information base that will allow a proper assessment of the contribution that FDI can make to her economic development.

4.2 FPI: Foreign Portfolio Investment

FPI is an emerging alternative source of international financing. Under this activity foreign investors supply funds through the channels of "Equity capital" that consists of foreign purchase of stocks (equity), certificates of deposits, and commercial papers of developing countries through international markets, such as: institutional investors, Global Depository Receipts (GDRs) and American Depository Receipts (ADRs). Institutional investors include institutions like pension funds, investment trusts, asset management companies, nominee companies and incorporated institutional portfolio managers. It cushions domestic companies without restraining control over the venture. This is because investors have no involvement in the management.
The different avenues of FPI are:

1) Securities Market
2) Equity Market
3) Real estate investment
4) Consumption loans

FPI have gained momentum in recent years as they alleviate the flight of domestic capital abroad caused by inflationary pressures and capital depreciation as a result of debt creating instruments.
Notwithstanding, it also augments the efficiency of investment since it focuses on return on capital and therefore encourages high standards of accounting, financial planning and corporate disclosure. The other benefits of FPI are:

a) It provides exposure to international capital markets.
b) Helps corporate in reducing hefty borrowings
c) Makes financial system more solvent

FII investments first started flowing to India in 1993. Portfolio investment inflows have since then been substantial, with the lone exception of 1998-99. During 2014-15, *foreign portfolio investors* (FPIs) brought in about US$ 41 billion to Indian equity and debt markets, making India the most attractive destination among emerging markets. FDI accounts for just 1 per cent of domestic capital formation in India. According to a study by *NCAER*, India has inward FDI stock worth $76.2 billion and outward FDI stock of $29.4 billion in 2008. The FDI inflows accounted for 5.8 per cent of gross fixed capital formation (GFCF) in 2007.
Another trend is witnessed in the shape of ***non-investment foreign-controlled Production***. Foreign influences over host country's economic activities can well occur without any capital investment at all. This occurs in a country in a number of *new forms of relationship – contracted manufacturing and farming, outsourcing of services, and franchising or licensing*. One increasingly common form of global production is that of contracted production within global production networks (GPNs) or global values chains (GVCs). In GPN production the sellers do not sell their product as commodities on the market, nor are they produced through MNC branches. Rather the producers make them under contract to the buyers. This is frequently the case with many labour intensive segments of production. Such as manufacture of garments or footwear. In such contracted global production, the buyers specify the output in great detail. The design, colour, fabric, types of accessories are all specified. Delivery times are fixed. Obviously, prices too are fixed. In this form of chain or network production the buyers do not have to undertake any investment in production facilities. Forms of governance, as they are called, enable the buyers to keep control of the output.
Such contracted production has extended beyond the relatively simple areas of garments and leather products to complicated electronic products, such as Laptop and other computers. The crucial point, however, is that there are forms of foreign control over production that do not involve foreign capital investment. The growth of such forms of

contracted production that provide foreign buyers control without capital investment is an important development for consideration.

5. Distinction between Foreign Direct Investment (FDI) and Foreign Portfolio Investment (FPI)

Basis	Foreign Direct Investment	Foreign Portfolio Investment
Meaning	It is the act of investing a certain capital in the chosen business enterprise that operates in foreign countries.	It is the purchase of one country's securities by nationals of another country
Control	Less volatile	No intention or interest to control an enterprise
Purpose	Earn Profits and Expand markets	Earn good financial return as in the case of investing in stocks, bonds, gold, art objects, etc.
Source	Undertaken by MNCs	Diverse sources such as a small company's pension or through mutual funds held by individuals

6. Challenges Faced by Foreign Investors

It is more than two decades since India dismantled its restrictive FDI regimes and replaced it with one of the most open and relaxed countries. However, even now the debate is about how much more open India should be towards FDI. FDI flows to India continued to be sluggish because foreign investors face major roadblocks. All this made India a far less attractive investment destination for FDI than most of its competitors. Indian policy-makers must weigh the reasons behind low volume of FDI inflow. India can't have foreign investment coming in from MNCs by overruling *Supreme Court* judgments and proposing laws backdated to tax investors.

To recapitulate the factors which limit the growth of FDI in India are:

(i) Inefficient and poor quality of infrastructural facilities,
(ii) Slow decision-making process,
(iii) Outdated laws and their inefficient implementation,
(iv) Weak credibility of regulatory system,
(v) Conflicting role of various agencies of government,
(vi) Bureaucratic procedures,
(vii) Corruption and red tape-ism, etc.

Geographically speaking, destinations matter because in which states FDI is going is an important aspect of attraction for the investors. According to *Ila Patnaik*, "in India, we have tied ourselves up in knots. Even at a time when the country needs capital inflows, it is not easy for the government to move at the required speed. The *U.K. Sinha* committee on capital controls documented the complex maze of capital controls that has taken the power of switching controls on and off, depending on the need of the hour, away from the government and into the hands of a number of financial regulators. But it is equally important that the system of controls now be re-examined and rationalised keeping in mind the objectives they serve".

6.1 Policy Measures Required to Remove Hurdles:

According to the, *World Investment Report* (WIR) asserts that '*simply opening an economy is no longer enough. There is a need to develop attractive configurations of locational advantages by capitalising on the synergy of endowments of factors of production*'. *There is the urgent need to improve the macro-economic and organizational framework 'so that the FDI policy looks more coherent'. 'The pace of improvement in infrastructure should be hastened to convert intent into action in a global market where everybody is out to woo investors. Bold and proactive moves, embedded in reality and governed with a will to improve the economic environment of the country are needed to bring about radical changes*'.

The government must strive to set up a single body for dealing with FDI matters in order to clear the complexities of foreign investors.

The importance of regulatory framework should not ignored at the national level. The policies on FDI should focus on '*maximisation of its contribution to India's development, rather than maximisation of the magnitude of inflows by itself*'. The problem before the nation whether a project can be cleared, from A to Z, in a short period.

In this backdrop, policymakers should realise that merely liberalising sectoral caps for FDI across more and more sectors will not augment capital inflows. Foreign entrepreneurs, just like their domestic counterparts, are driven primarily by *return on investment* (ROI) considerations. And to make India an attractive destination for them, sector regulators need to deliver good and better governance with less government intervention.

But there is still much of the space is there to make India a lucrative destination for foreign investment. Notwithstanding this, it requires reforms both in legal and administrative implementation, then FDI, which is a real long-term capital will on its own find way to India. FDI does not flow merely from desirable economic policies, it also requires desirable political actions. The insurmountable problem is to bring in the desirable change in the mind set of India's policy-makers. The formulation of an effective strategy mainly requires a vision of development, coherence and coordination between its different objectives. What India urgently needs is to have a pro-active policy to attract more FDI. Unfortunately, *the infrastructure, be it power, ports, roads or civil aviation, continues to be pathetic*.

The fetters must go as India needs inflow of capital that is accompanied by technology and business expertise. It is high time for India to have an *Investment Promotion Agency* (IPA) which will work to promote the country as an investment destination, targets investors and provides after-care service in a holistic manner. Currently these functions are dispersed in different government bodies. The investment commission (IC) could be an effective IPA by undertaking primarily five functions: (a) *policy advocacy*, (b) *image-making*, (c) *investment promotion, including Investor targeting*, (d) *after-care of the investors*, and (e) *networking*, both globally and within the country with state level IPAs. It is better to have a negative list and open up all the other sectors for foreign investment. For a country of India's size the magnitude of the foreign investments cannot and will not be a cure-all, a panacea for all the problems. "It is neither a necessary nor a sufficient condition for India's development. But, if judiciously treated, it could be a handy aid in this process".

6.2 *Policy Suggestions*

For reaping positive contribution from foreign investment one should look at the following:

(i) investment should facilitate India's penetration into world markets and MNCs firms must ensure exports and boost India's competitiveness;

(ii) India needs the best technology for producing precision instruments, armaments, life-savings drugs and in general for all exportable goods,

(iii) For achieving essential technology transfer in '*high-tech*' fields, besides equity participation, India should have a policy-package to acquire foreign technologies through the route of joint ventures, licensing technical and service contracts, etc.

(iv) the know how that the foreign investments bring in must percolate down to indigenous producers; and

(v) FDI can be useful only if it is well coordinated, monitored and tailored so as to fit into an investment process that leads to growth in country's national income and employment generation.

The government has a long haul ahead in cleaning up the investment environment. Domestic investment has to lead the way, not foreign investment keeping in mind FDI was under 8% of total investment in the country. FDI inflows may not give any boost to the government's ambitious '*Make in India*' campaign. The disaggregated data on FDI inflow indicates a much different picture compared to the general perception. *Foreign investors are more concerned about decision making, transparency, consistency and corruption, and unless the government can tackle these, foreign jaunts will remain just foreign jaunts*. One way to create a better image of India as a business location will be to introduce stability in the system. "FDI strategy is an art not a science. Strategy has to suit the particular conditions of the country at the particular times and evolve as its needs change and its competitive position in the world alters". Whether or not it achieves its potential will be powerfully influenced by how the Indian government manages its business policy environment. While the quantity of FDI is important, equally important is the quality of FDI. However, it is good to remember that '*foreign capital is a good servant, but a bad master'*.

7. Debt Creating Flows

Debt-Creating Flows are in the form of External Commercial Borrowings, Foreign Remittances, in general, and Official Development Assistance (or Foreign Aid), in particular, has also a significant role to play in supplementing the domestic financial resources and in developing the productive capacity of the recipient developing economies, in the above-mentioned areas, where FPI has a limited role. These flows are considered as debt-creating because these involve the repayment obligations in the form of amortization and interest payments, and hence create debt burden in the recipient countries.

7.1 External Commercial Borrowings (ECBs)

It refers to the loans procured from the private international commercial banks and financial institutions, such as: International Finance Corporation (Washington), Asian Development Bank, Asian Finance and Investment Corporation Ltd., etc.; securitized instruments like floating rate notes and fixed rate bonds, and loans from semi-government export credit agencies, like DEG Germany, CDC UK, Nordic Investment Bank; and foreign currency convertible bonds, till these are converted into equity shares. These borrowing are usually taken by the developing countries at the market rate of interest for the purpose of meeting their BOP requirements. But these ECB accruals depend upon certain factors, such as international interest rates (particularly the US dollar denominated), demand of domestic industry for investment, expectation of exchange rate fluctuations, hedging costs and credit rating of the recipient country by the international credit rating agencies, like the Standard and Poor's Outlook, Moody's Investor Service, Duff and Phelps Credit Rating, and Japanese Credit Rating Agency, etc.

However, too much dependence on ECBs, in addition to a high cost method of raising resources, is fraught with serious risks. India's experience during the 1980-90 periods provided an important lesson for developing countries. Even during 2003-04 ECBs recorded net outflows amounting to US $ 6.6 billion in the capital account for the third successive year, since 2001-02. This is simply that dependence on new money from commercial sources to finance current imports is likely to make the economy extremely vulnerable and complicate the task of balance of payments management during the periods of domestic economic, social or political difficulties. Banks are extremely susceptible to adverse developments in any sphere and can quickly withdraw support with or without adequate cause. In good times, international banks compete fiercely with each other for business. In hard times, they act in unison. The withdrawal of support by a single bank can trigger off a chain reaction among all other banks. Thus, it is not safe for a developing country to rely too much on ECBs, particularly, for short-term credit.

7.2 Foreign Remittances

Under this non-resident bank deposit schemes, expatriate nationals residing abroad are allowed to open bank accounts in the recipient country freely, out of the funds remitted from abroad or foreign exchange brought in from abroad or out of funds legitimately due to them. For instance: in India, RBI has granted general permission to the banks which are authorized to deal in foreign exchange, to open such accounts freely in the form of Foreign Currency Non-Resident (Bank) Accounts, Non-Resident (External) Rupee Accounts and Non-Resident (Non-Repatriable) Rupee Deposits, etc. However, like ECBs, foreign remittances in the form of non-resident emigrant deposits are also high cost method of raising external resources, for, these deposits mainly depend upon the interest rate differential between the domestic recipients and the foreign countries. If the interest rate increases in the other foreign countries, larger external inflow in the form of foreign remittances may not be expected from the non-resident emigrant deposits. In other words, like ECBs, these deposits are also 'fair weather friends'. If conditions are favorable, the growing volume of such deposits underlines the expatriate investment community's increasing confidence in the recipient country and if the conditions turn unfavorable for the country, large scale outflow from such deposits can plunge the recipient country into a serious crisis, as has happened in India in the early 1990s. Besides this, there are fiscal costs involved in terms of the interest outgo on these deposits which tend to increase along with the increase in the volume of the deposits. Hence, the past experience indicates that too much dependence on such deposits is also not a rational policy.

7.3 Official Development Assistance (ODA)

The Official Development Assistance (ODA) also known as 'foreign aid', in the form of the official flows from bilateral sources, like friendly countries, and multilateral sources, such as: the World Bank (including IBRD and IDA), Asian Development Bank (ADB), and International Fund for Agricultural Development (IFAD), etc., on concessional and non-concessional terms, is another major external debt-creating source used to supplement the domestic financial resources in the recipient developing countries. Though the term 'foreign aid' nevertheless remains fuzzy, but refers to the congeries of governmental programmes through which funds, goods and services, additional to those normally acquired are made available to the developing countries for the benefit and welfare of their citizens, in cash or kind, as outright grants or loans, on concessionary or non-concessionary terms including technical assistance in the form of technical equipment, know-how, expert human resources, and training to the local counterparts. The foreign aid can be used for improving productive capacity in certain key areas mentioned earlier, where PFI (Private Foreign Investment) is unattractive. It can also be used in some other areas. First, as budgetary support for macroeconomic stabilization and structural reform measures in a developing country like India, particularly at a time, when 'the world's economies move inexorably to embrace market-friendly policies, public sectors are reorienting themselves, and downsizing, 'less is better' has been the cry. Second, foreign aid is expected to attenuate the poverty by meeting critical needs in areas outside the private ambit, such as: primary health and education, urban infrastructure, rural and state roads, etc., and in many cases 'crowding in' private investment. Last, concessional external assistance is expected to provide stable inflows, long maturities, and low interest charges that support a continued low debt-service ratio, and the stable capital account. Hence, if domestic savings are low, and the prospects for foreign investment or borrowings are bleak, then foreign aid should be given in order to achieve the desired rate of the growth.

Therefore, continued high levels of support by the donor community will remain significant for a developing country like India, although foreign investment, particularly the FDI, has also been playing an increasing role, since 1990. Even though, in an ideal scenario, one may think of discontinuing foreign aid, if not immediately, at least over a period of time, but this may not be possible for a developing country like India, for, India is home to 40 per cent of the world's poor. Further, two-thirds of all Indian women and two-fifths of all Indian men are illiterate and India ranks 119th out of 169 countries in the Human Development Index (UNDP Report, 2010). The constraints imposed on account of budgetary reasons, and also on account of the fact that benefits of international expertise and technology are required at least in certain critical areas. Therefore, foreign aid still has an important role to play in the economic development of a developing country like India.

8. Summary

In this module we have studied:

- There are two types of external resource flows namely debt creating flows which include external commercial borrowings, foreign remittances and official development assistance and non-debt creating flow which includes foreign direct investment and foreign portfolio investment.
- Non debt creating flows are the flows financial resources in the form of Foreign Investment which do not involve any repayment obligation and hence do not create debt burden on the recipient country. These non-debt-creating flows mainly are of two types: Foreign Direct Investment (FDI), and Foreign Portfolio Investment (FPI).
- Foreign direct investment is the act of investing a certain capital in the chosen business enterprise that operates in foreign countries.
- Foreign portfolio investment includes supply funds through the channels of "Equity capital" that consists of foreign purchase of stocks (equity), certificates of deposits, and commercial papers of developing countries through international markets, such as: institutional investors, Global Depository Receipts (GDRs) and American Depository Receipts (ADRs).
- External commercial borrowings refers to the loans procured from the private international commercial banks and financial institutions, such as: International Finance Corporation (Washington), Asian Development Bank, Asian Finance and Investment Corporation Ltd., etc.; securitized instruments like floating rate notes and fixed rate bonds, and loans from semi-government export credit agencies, like DEG Germany, CDC UK, Nordic Investment Bank; and foreign currency convertible bonds, till these are converted into equity shares.