

2. Foreign Capital Paradox in India – Economy

Despite India's world-leading GDP growth, its foreign capital inflows have fallen to their lowest levels since the 2008 financial crisis. This paradox is driven by factors like maturing private equity investments being exited, high market valuations, and a widening trade deficit.

The Foreign Capital Paradox in India

Despite being the world's fastest-growing major economy, with an average annual GDP growth of 8.2% between 2021 and 2024, India is experiencing a decline in foreign capital inflows. This situation, where high economic growth is not matched by commensurate foreign investment, is termed the "foreign capital paradox". Recent GDP figures confirm this strong momentum, with growth at 7.4% in Jan–Mar 2025 and 7.8% in Apr–Jun 2025.

Trends in Capital Flows

Definition – Net capital flows into India encompass a range of sources, including foreign investment, commercial borrowings, external assistance, and non-resident Indian (NRI) deposits.

Historical Lows – In the fiscal year 2024–25, net capital flows stood at just \$18.3 billion. This is the lowest figure recorded since the \$7.8 billion during the global financial crisis of 2008–09. It is significantly lower than the all-time high of \$107.9 billion in 2007–08.

Continuing Decline – The downward trend has persisted, with capital inflows during 2025 falling by over 40% compared to the same period in 2024, even as the economy grew by a robust 7.8% in the latest quarter.

Understanding Net Foreign Direct Investment (FDI)

Formula – Net FDI is calculated as Gross FDI Inflows minus the capital repatriated by foreign firms and the outward FDI made by Indian companies.

$$\text{Net FDI} = \text{Gross FDI Inflows} - (\text{Repatriation by foreign firms} + \text{Outward FDI by Indian firms})$$

Key Components

Gross FDI Inflows – This is the total new investment made by foreign entities in India, such as setting up factories, acquiring local businesses, or expanding existing operations.

Repatriation & Disinvestment – This includes profits or capital that foreign companies send back to their home countries and funds generated from selling their assets or shares in Indian firms.

Outward FDI – This refers to investments that Indian companies make in other countries, like acquiring foreign companies or establishing international subsidiaries.

Why it Matters

A positive Net FDI indicates that more foreign capital is entering the country than leaving, which is generally seen as a sign of strong economic health and attractiveness. A low or negative Net FDI might suggest that capital is being withdrawn or that Indian firms are investing more abroad than foreign firms are investing in India. While not always a negative sign (it can reflect economic maturity), it requires careful analysis.

Reasons for the Dip in Capital Flows

Private Equity/Venture Capital (PE/VC) Exit Cycle – A significant portion of FDI into India since the mid-2010s, which peaked in 2020–21, came from PE and VC funds investing in sectors like e-commerce, fintech, retail, and green energy. These were medium- to long-term investments. Now that they have matured, investors are exiting to realise profits, leading to capital outflows.

High Market Valuations – Current high valuations in the Indian market encourage existing investors to sell their holdings (profit-taking) and discourage new investors from entering at high prices.

Global Factors – Geopolitical and economic uncertainty, including ongoing trade wars and U.S. tariffs on Indian goods, have made global investors more cautious.

Merchandise Trade Deficit – India's imports of goods significantly exceed its exports. This deficit has more than tripled since 2007–08, reaching \$287.2 billion in 2024–25.

Investor Perception – Foreign investors often look beyond headline GDP numbers and focus on more specific metrics like –

1. The sustainability and profitability of corporate earnings.
2. The overall business climate and regulatory environment.
3. Reasonable market valuations that justify investment. If earnings don't support high valuations, investors prefer to exit.

Implications of Declining Inflows

Economic – It can create stress on external sector financing (managing the flow of funds between India and the world) and lead to a higher current account deficit.

Currency – Capital flight can put downward pressure on the Indian Rupee, leading to its depreciation.

Investor Confidence – A sustained decline suggests weak participation from global investors in India's growth narrative.

Policy Space – It may constrain the government's capacity to finance development and growth projects using external financial resources.

Way Forward – Policy Recommendations

Deepen Structural Reforms – Implement comprehensive reforms in land, labour, and taxation to improve the business climate and attract stable, long-term FDI.

Encourage Long-Term Capital – Prioritize attracting investments into critical sectors like infrastructure, green energy, and manufacturing.

Strengthen Corporate Earnings – Introduce measures to boost corporate productivity, lower operational costs, and reduce the compliance burden.

Enhance Export Competitiveness – Diversify export markets beyond the US and EU and strengthen the "Make in India" initiative.

Stabilise Macroeconomic Fundamentals – Maintain adequate forex reserves and implement prudent fiscal and monetary policies to ensure currency stability.

Build Investor Confidence – Foster a transparent policy regime, predictable taxation, and a consistent reform agenda to assure investors of a stable and reliable economic environment.

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