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DIRECT PROPORTIONAL **RELATIONSHIP BETWEEN FDI** **AND CAPITAL MARKET GROWTH**

Authored by - Abhishek Singh

According to economic theory, FDI may have both positive and negative effects on stock prices, depending on the time horizon considered. In the near term, rising stock prices can be a sign of a healthy economy, a welcoming investment climate, and a country that is open to foreign investment. Thus, short-term fluctuations in FDI are directly related to stock market activity. Yet, causation is backwards in the long term. Foreign direct investment (FDI) may have an indirect effect on the development of stock markets if it promotes rapid technical advancement and economic growth through the transfer of know-how and technology. On the other hand, one may argue that the existence of FDI infows boosts investor confidence and motivates policymakers to enact market-friendly rules. The development and volume of trading on domestic stock markets are bolstered, and the number of investors grows, as a result. The directionality of the link is unclear for most nations, however, and must be probed empirically.

The world of today is interconnected. A globalized economy necessitates worldwide communication, and financial transactions take place in a variety of economies. A developing country, often known as a least developed country, is one that has a poor economic foundation, insufficient infrastructure, and a low human development index (HDI) in comparison to other countries. Income and capital accumulation are often lower in emerging nations such as Bangladesh, Nepal, and India. As there is a strong desire for industrialization, development, and economic growth, these countries are in desperate need of funds. They must address the absence of finance, either locally or globally. As the home front cannot satisfy all of the nation's needs, these countries must seek assistance from other sources. Countries such as India have often suffered with a shortage of revenue and funds for national development. For example, foreign support was acquired from Russia, the United Kingdom, and Germany to help launch steel facilities at Bhilai, Rourkela, and Durgapur. Furthermore, corporations like as Ford and General Motors have made investments in numerous nations throughout the globe. These two

giants established plants and purchased equipment in nations such as Brazil, Mexico, Vietnam, South Korea, and India to manufacture automobiles. As a result, foreign investment gives income to developing countries like India. Some of the prominent multinational firms that have invested in India include TMI Ltd (Mauritius), Cairn UK Holding, Oracle Global Ltd (Mauritius), Mauritius Debt Management Ltd, Vodafone Mauritius Ltd, and CMP Asia Ltd.

India gained independence in 1947. Due to the concern of monopolies and for-profit corporate groups at the time, the public sector got more attention than the private sector's growth. In 1991, India's financial status was not ideal. For two weeks, the country could not even pay for imports. The fiscal deficit, the unfavorable balance of payments, the Gulf War, the decline in foreign exchange reserves, inflation, and poor public performance all contributed to a situation so dire that the government of Shri Chandrashekhar, who was in office at the time, was forced to mortgage its gold reserves in order to pay off its external debt.

Given the severe situation, India's government was forced to pursue a new economic plan in 1991. The implementation of the liberalization strategy exposed the country on a worldwide scale. G. V. Ramakrishna, the chairman of Finance Minister Dr. Manmohan Singh at the time, proposed that the FLLs be authorized in 1992. Following that, a detailed procedure was created, and SEBI was registered. National boundaries no longer constrain investors. Due to liberalization, investors may now readily invest in numerous economies all over the globe. Until the 1990s, India did not accept foreign private investment. Throughout the 1990s, numerous emerging economies started to enhance their markets for foreign private investment as a result of the Trans-Pacific Partnership (TPP).

The International Monetary Fund and the World Bank. In September 1992, India opened its stock market to overseas investors. Since 1991, the Indian stock market has gone through various changes and has become stronger by the day.

A company may acquire funding from a number of sources. Long-term finance may be secured via institutional loans or the issue of securities. You may also borrow money from other organisations on a short-term basis. As a consequence, corporate units may raise cash by borrowing or the issuance of securities (both short-term and long-term). Financial markets act as a conduit for lenders and borrowers. All entities and organizations that lend money to companies and government agencies are referred to as the 'financial market.' Its two components are the money market and the capital market. The capital market is concerned with

the provision of medium and long-term loans, while the money market is concerned with the provision of short-term credit.

FDI THEORY BASED ON STRENGTH OF CURRENCY

This theory as propounded by Aliber¹ attributes the flow of foreign direct investment on the strength or weakness of a country's currency. According to Aliber's argument, an economy's ability to attract FDI depends on the relative strength of its currency. Aliber argued that countries with weaker currencies were better able to entice FDI than those with stronger currencies, because of the larger potential for profiting from the disparity in market capitalization. Most economists have argued that even if this theory holds water for FDI from developed to developing economies, it fails to establish relevance when dealing with FDI between two developed economies with equal strength currencies, and it also fails to explain the rationale for an investor from a developing nation with a weaker currency to invest in a developed economy with a stronger currency. It is impossible to overstate the importance of this notion to a country with a rapidly growing economy like Nigeria.

DEPENDENCY THEORY OF FDI

Foreign direct investment is said by dependency theorists to have no beneficial effects on the receiving nation's economy and to instead contribute to the perpetuation of the dependent connection between the advanced economy and the developing country. Developed countries frequently join economies still in their formative stages armed with state-of-the-art machinery and superior tools, killing native microbusinesses via the aggressive use of superior technology and marketing. Most developing countries blame their balance of payment woes on FDI, as the gains made by multinational corporations are typically remitted to the investing nations. According to Todaro,² the adverse effects of these investors' actions undermine developing nations' potential for progress and generate substantial overturn flows in the form of profits and dividends. The labor-saving technologies that accompany such large investments have an impact on the demand for domestic labour, which in turn keeps poverty levels high and savings low, making it impossible to challenge foreign investors' grip on our stock market.

¹ Aliber RZ. A theory of direct foreign investment in Kindlebenger CP, (ed). The International Cooperation MT Press, Cambridge, MA, United States; 1970.

² Todaro MP, Smith SC. Economic development (8th Ed.) Delhi Pearson Education; 2003.

MODERN PORTFOLIO THEORY

The goal of portfolio theory is to strike a balance between maximising return and avoiding risk. Investments should be chosen to spread out risk without lowering return expectations. Although it cannot take the place of a knowledgeable investor, it may be a useful addition to a portfolio that is actively managed.

Investments such as stocks, bonds, and mutual funds are the building blocks of a portfolio. Portfolio allocation refers to the distribution of these holdings. The success or failure of a portfolio is entirely dependent on its allocation. During the first three months of each year, most investors reallocate a small portion of their retirement funds. Most resource distribution choices are made intuitively or emotionally, rather than using objective criteria.

MARGINAL EFFICIENCY HYPOTHESIS

According to this idea, investors should consider the Marginal Efficient of Investment (MEI) and the current market interest rate while making investment selections. Anyanwu³ traced “the theory to John Maynard Keynes; Keynes defined the IRR as the rate of discount which will make the present value of the series of annuities given by the returns expected from the capital asset during its useful life just equal its supply price. Keynes also utilized the concept of marginal efficiency of capital (MEC) in the development of marginal efficiency theory. He defined MEC as the rate of discount that equates the current cash outlay with the present value of future cash receipt. The marginal efficiency hypothesis states that the marginal efficiency of investment will be compared to the market rate of interest and such comparison will generate a set of decision rule for firms. The appropriate rule is: $MEI \geq r$, accept investment proposal or $MEI < r$, reject investment proposal. The rule further defined, r , as the market rate of interest and states that where $MEI = r$, investment is considered to be at its optimum or equilibrium level. Most investment decisions in the stock market are believed to be influenced by marginal efficiency concept.”⁴

³ Anyanwu JC, Oaikhenan HE. Modern macroeconomics: Theory and application in Nigeria. Joanee Education Publishers Ltd, Onitsha; 1995.

⁴ Ibid.

1.1 CAPITAL MARKET

The capital market is the financial market in which debt and equity securities, as well as other stock market instruments, are purchased and sold. Activities that generate money from one entity and distribute it to others are covered. It also moves money from less profitable pathways to more lucrative ones. It is a market available to long-term investors in which assets such as bonds, equities, and commodities are exchanged. The capital market includes both the main and secondary markets. The secondary market is where existing securities or securities that were previously issued in the main market are traded. The main market is where fresh issues are sold.

Sub - Markets of Capital Market

- a) Corporate Securities Market: - The corporate security market is used by corporates organizations to raise their funds by issuing securities in the security market.
- b) Government Securities Market: - Long-term government debts and treasury bills are included in this market. The government can raise funds through the security market.
- c) Derivatives market: - This market is used to trade the underlying assets like Forward, Futures, Options Contract, Currency Swap, Commodities etc. Nowadays this market is gaining popularity.
- d) Debt Market: - This market deals in debentures and bonds related to private funds and public financial institutions and bonds of Public Sector Units.
- e) Mutual Funds: - Mutual Funds are the pooled funds created to invest in the security market as a portfolio of different securities. UTI is an example of a mutual fund.

1.1.1 STRUCTURE OF CAPITAL MARKET IN INDIA

The structure of the Indian Capital Market can be described by using the following heads:

MARKET

Capital Markets are categorized into two components of capital market:

Primary Markets

The primary market primarily concentrates on new securities that are publicly traded for the first time. As a consequence, it is also known as the new issue market. The primary market's principal goal is to make it easier for firms to transfer freshly issued shares to the general public. Financial institutions, banks, HNIs, and others are the primary investors in this sort of market.

Secondary Markets

The secondary market is divided into two parts: the auction market and the dealer market. The auction market's open protest approach involves buyers and sellers congregating and announcing the prices at which they are ready to acquire and sell their assets. In India, two such capital markets are the National Stock Exchange and the Bombay Stock Exchange. However, trading in dealer marketplaces is done over electronic networks. The majority of small investors do their business via dealer marketplaces.

INSTRUMENTS

There are five types of instruments in the capital markets in India:

Equities

The entire net difference between a company's assets and liabilities is referred to as 'equity' or 'shareholders' equity.' Divide the share price by the total number of shares outstanding to get the market capitalization of a firm with publicly traded shares.

Debt Securities

Owners of debt securities have the right to receive recurrent interest payments. Debt securities, as opposed to equity securities, demand return of the principal borrowed. The perceived creditworthiness of the borrower will impact the interest rate on a loan instrument.

Hybrid Securities

A single financial security called hybrid security combines two or more distinct financial instruments. Often referred to as 'hybrids,' hybrid securities typically incorporate both loan and equity features.

Regulator

The Securities and Exchange Board of India (SEBI), among other things, is a government institution that oversees capital markets to safeguard investors from fraud. The word 'regulation' refers to steps adopted by government-created institutions to control specific parts of the capital markets. It is the only entity in charge of the Indian capital market.

BANKING SECTOR IN INDIAN CAPITAL MARKET:

After researching this dissertation, I got to the conclusion that the PSU model dominates the Indian banking market in all dimensions. In terms of service quality and coverage, State Bank

of India is the main public sector bank, followed by Bank of Baroda and Punjab National Bank. Regional rural banks and cooperative banks are experiencing difficulties as a result of their market shares and service standards.

In India, foreign banks compete for customers, but their reach is confined to a few big cities. Despite deploying cutting-edge technology, they have failed to gain Indian clients' CONFIDENCE AND ATTENTION.

1.1.2 CAPITAL MARKET REGULATION

In light of the global finance markets' increasing significance, regulations are a strict need. The growth of the capital market is necessary for the development of a market economy. Securities must be regulated as part of a capital market's regulation for that market to operate more effectively and fairly.

The system of administrative controls over capital issues has been removed, and the price of capital issues is now largely decided by the market. This is consistent with the overall goals of the continuing programmes of economic reform. The Securities and Exchange Board of India (SEBI), which is based in Bombay, is currently principally in charge of regulating the capital markets and safeguarding investors' interests. The laws and authorities that govern the Indian capital market are as follows.

LEGISLATIONS

- The Capital Issues (Control) Act, 1947
- The Securities and Exchange Board of India Act, 1992
- The Securities Contract (Regulation) Act, 1956
- The Depositories Act, 1996
- The Companies Act, 2013

REGULATORS

- Department of Economic Affairs (DEA),
- Department of Company Affairs (DCA),
- Reserve Bank India and
- Securities and Exchange Board of India (SEBI)

1.2 FOREIGN DIRECT INVESTMENT

In 1991, the Foreign Exchange Management Act allowed for the entry of foreign capital into India (FEMA). Direct investment in a firm is known as FDI. It is beneficial for the creation of commodities or the delivery of services. Investments made via the purchase of shares are not included.

A beneficiary and an investor are the two parties involved. Investor contributes capital, expertise, management, and technology to the recipient's operation in a foreign nation in exchange for earnings or royalties from the recipient. The receiver is the other party. Investor makes an investment in the recipient's company. Therefore, foreign investment promotes global development by facilitating the exchange of talent, resources, and information across many continents. By working together, money and technological know-how are distributed globally and unite all trade nations and businesses to one location.

A business unit in a foreign nation that a company located in another country controls the ownership of. Joint ventures, mergers, and acquisitions, building new facilities, reinvesting earnings from international businesses, and international loans are all included.

The Indian government has imposed restrictions on foreign ownership of stock in a number of sectors. Additionally, overseas corporate bodies (OCBs) are prohibited from making investments in India.

Researchers and economists who study the effects of foreign direct investment (FDI) inflows into developing countries have long been worried that these investments have significantly greater effects on the host nations than are reflected in national FDI figures.

According to economic theory, FDI makes three major contributions to a host nation:

1. The financial capital invested by foreign firms;
2. The export market access provided by them;
3. The faster technology development that is expected to occur through technology transfer as part of the FDI package.

Each of these is thought to aid the host nation in industrial catching up quicker than would

otherwise be possible and so support economic growth and development in the nation.

Typically, the first two elements are investigated by examining:

1. The shares of FDI in total external capital inflows into a host economy and gross domestic capital formation;
2. The extent and pattern of foreign ownership in various sectors in terms of the industrial composition of FDI inflows and sources of FDI; and
3. The export-orientation of foreign-invested firms.

By linking the ownership structure and export-orientation of enterprises at the industry level, researchers have attempted to investigate the export contribution of FDI in more in-depth studies. However, since domestic partners in foreign-invested companies typically rely heavily on the technological and managerial expertise, marketing networks, etc. of their foreign partners, the role played by foreign enterprises may be more significant than suggested by the average share of ownership in particular industries. This is why researchers have used the methodology of case studies to examine issues related to technology transfer within the direct invested company and the degree of domestic forward and backward integration achieved by foreign invested firms in order to examine the aforementioned third aspect of whether FDI contributes to technological upgradation and skill formation in the host country.

1.2.1 MEANING OF FOREIGN DIRECT INVESTMENT

As previously noted, FDI is one of the several forms of financial flow that are permitted for different goals and flows from private sources or from governmental sources, including portfolio investment, foreign institutional investment, loans, international assistance, grants, etc. The financial assistance provided by the International Bank for Reconstruction and Development (IBRD), the International Development Association (IDA), and the Regional Development Banks (RDB) in Latin America, Africa, and Europe is included in the public source. The least developed nations can access the financial assistance offered by these organisations for social and economic development, in addition to loans and credits from the Inter-American Development Bank, the African Development Bank, the Asian Development Bank, and the European Bank for Reconstruction and Development. These financial entities will provide funding for initiatives related to infrastructure, agriculture, education, and other aspects of development. Additionally, they provide the private sector with loans and credits on more advantageous conditions.

In addition to the previously listed governmental sources, private sources include portfolio investments, FDI, and debt financing such as bonds and loans. Profit from investments is always the goal of private sources. 'Investments are made to acquire a long-term stake in a business that is functioning in an economy other than that of an investor, and the investor's objective is to exercise an effective choice in the management of an enterprise,' the International Monetary Fund (IMF) states. There are three types of FDI.

- New investment is referred to as 'greenfield investment' (New projects)
- Brownfield investment consists of mergers and acquisitions as well as
- Establishing joint ventures between international and local businesses.

Trade growth is impossible without FDI since the two are intertwined and have a strong relationship. Trade and investment are inextricably linked, which is why the Uruguay Round of the WTO included GATS, a multilateral agreement on trade in services that includes insurance, banking, transportation, and health care, among other industries. Trade in services depends on investment, which is not possible without trade in services. In almost every state, FDI is permitted with a cap limitation in these service areas.

The definition of FDI under domestic investment laws, BITs, and RIAs differs from the MNC definition, which includes the rights and assets of MNCs related to the projects for which they are founded.

According to the OECD, FDI refers to and encompasses all forms of physical and intangible assets that the investor directly or indirectly owns and controls, including the following:

- a. An organisation with a legal personality, such as MNCs, businesses, and joint ventures between the public and private sectors.
- b. Stocks, shares, and other types of equity ownership in a business, as well as associated rights.
- c. Debentures, loans, bonds, and any other forms of debt and rights resulting from them.
- d. Rights under contracts.

Due to the OECD's very broad definition of FDI, which encompasses every facet of foreign investment, many developing countries have yet to sign up to the organization's international agreement on FDI. Few BITs allow FDI in particular areas, whereas other BITs have prohibited FDI in the same sectors. The definition of FDI will always vary depending on the treaty, the industry, and the licencing requirements. It should also serve the practical goal of putting legal instruments into practise. The scope of investments and the legal framework should be

determined by how FDI is defined in investment treaties. Additionally, the concept of FDI differs from state to state. The capital-importing state defines FDI in a limited sense to safeguard its internal economy and retain its sovereignty, while the capital-exporting state defines FDI broadly to safeguard its citizens' interests in host countries. However, portfolio investment is included in the definition of FDI under the OECD and the World Bank Investment Guidelines, which is a problem that has to be appropriately resolved.

1.2.2 FOREIGN INSTITUTIONAL INVESTORS (FIIS)

FII is for a recognised institution from outside of India that plans to invest in Indian assets. Instead of participating directly in the businesses of other nations, international investors might trade with, hold, or invest in listed or proposed to be listed instruments of the local stock market. Consequently, an investor or investment or investment fund that is from or registered in a nation other than the one in which it is now investing is referred to as a foreign institutional investor or FII. An organisation founded or incorporated outside of India that seeks to invest in securities in India is referred to as a 'foreign institutional investor' (SEBI Regulation, 1995). In financial markets including the stock market, money market, and foreign currency market, FII makes investments. Mutual funds, hedge funds, and pension funds are examples of institutional investors. They are significant dealers, hence. They may use a selling high and buying low technique to influence the market by building a dynamic model. They become both noise traders and financial strategic traders as a result. As a result, the nation must continue to attract FII investment into the financial industry.

The SEBI (FII) Regulations, 1995 were amended in February 2004 to add a new regulation that states that 'An FII or sub-account may issue, deal in or hold, offshore derivative instruments such as Participatory Notes (P-Notes), Equity Linked Notes (ELN) or any other similar instruments for the securities which are listed or they are proposed for listing in the stock exchange in India, only in favour of those entities which are regulated by any relevant authority in the country.' On September 14, 1992, the Indian government granted FII clearance. For allowing FII to invest in financial products, the whole policy framework was established. The first registration rules for FII were provided by the Indian government, and FERA mandates that RBI clearance be obtained. The registered FIIs had the ability to invest in all recognised stock exchanges via a specified bank branch, purchase, sell, and realise capital gains on such assets, as well as nominate domestic custodians to take custody of their

investments. Under FERA, both SEBI's registration and RBI's general licences were to be valid for five years before being renewed. The 1992 government regulations also stipulated registration eligibility requirements, such as track record, professional competence, financial soundness, and other pertinent factors, including registration with a national regulatory body. The sizeable Indian stock market is a popular destination for investors. In recent years, the expanding Indian market has drawn the attention of both local and international investor communities. Institutional investors, among whom foreign investors are of particular significance, are responsible for a significant portion of the investment.

However, there are a number of criteria that international investors should consider before making an investment.

As a result, the situation has altered, making the investing choice more delicate. The use of technology has increased investors' awareness of market activity. Additionally, the stock market has seen several adjustments throughout time. The routes through which developing nations obtain money in the form of foreign currency are FDI and FII. Additionally, it aids in the expansion of their foreign currency reserve. Foreign investors find the Indian market to be appealing in modern times since there are good circumstances and excellent returns accessible. Additionally, the globe wants to invest in India because of Mr. Modi's 'Make in India' initiative because of the high returns. The facts that India may perceive and continue 'Making in India' and so have a favourable influence on the stock market and inflows of capital from international investors are supported by empirical data from September 2014 to December 2015 as well.

Through FII investment, the growth of the Indian stock market is highlighted. The economic report for 2012–2013 showed that FII is essential to the development of the Indian market and that greater FII inflows were a major factor in the Indian stock markets' ranking as the second-highest performers internationally.

The amount of foreign money entering the Indian economy increased from 1992–1993 to 2014–2015, and India was predicted to provide investors attractive returns in the future. When the international economy were collapsed and shattered, the Indian capital market showed signs of stability and development. The Indian economy was unaffected by the 2008 financial crisis and quickly recovered following the blow.

India's economy is now one of the ones expanding the quickest worldwide. The rise of the Indian economy is being watched closely by the main industrialised economies. The day when people thought of India as an impoverished nation has long since passed. It is now becoming more prevalent across a variety of sectors, including infrastructure for technology, agriculture, business, and the financial market. It has shown its worth in practically every industry.

India Development Update, the World Bank's flagship magazine published every two years, has published an issue with the theme 'India Growth Story.' The expansion of India during the last 50 years is discussed in this issue. It is a more promising and stable market because to the steady rise in a number of industries, including agriculture, services, and industry. The nation will reach new heights as a result of the changes implemented in several sectors during the last few years.

When noting that previous direct investment was considered as international capital transfer alone, the theories of stock market and portfolio investment provide a fundamental framework for explaining the origins of FDI. At first, economists grouped FDI with other forms of portfolio investment and blamed interest rate differentials for the phenomenon. It was widely held that the interest rate determines where money goes, and that money will flow to the economy that offers the highest return. Hymer, however, maintained that this perspective was inadequate since it did not account for the importance of control in managerial settings. Market flaws, oligopolistic and monopolistic concerns, absolute/comparative trade advantage, religious/political motivations, and so on have all been proposed by various thinkers as causes for FDI. Foreign direct investment theories based on currency strength, FDI dependence theory, current portfolio theory, and the Marginal Efficiency Hypothesis will all be taken into account in this analysis.

CONCLUSION

Global foreign direct investment is associated with economic expansion, as our research shows. Yet, without some other sort of mediation, the link is tenuous. We find strong evidence of an inverted U-shaped link between a country's income and the magnitude of the economic impact of foreign direct investment. There is a greater impact as one moves from low- to middle-income nations. Yet, it declines once again as people move to nations with a high standard of living. In addition to facilitating capital accumulation, FDI facilitates the incorporation of beneficial externalities, such as novel inputs and advanced foreign technology,

into the production process. Hence, compared to established nations, emerging economies that have a greater need for investment and a greater need for sophisticated technologies benefit more from FDI, or experience a greater influence on growth as a result of FDI.

SUGGESTIONS

Strategic Disinvestment: India's current foreign direct investment (FDI) situation is quite precarious, therefore we need to take immediate action to provide a stimulus that will help turn things around and inject some cash into the economy. The government should lay out a detailed plan to attract international investors and private citizens to the auctioning process. If done right, this strategy can serve as a magnet to attract foreign direct investment. The public sector, notorious for its inefficiencies, will also benefit from the influx of foreign management, technological skills, knowledge, and a competent work culture.

FDI in trade (multi-brand retail): It is time for Indian policymakers to think long-term and create a strategy that would boost productivity at every stage of the supply chain. The infrastructure, transportation, and storage systems of India's retail sector are in a dismal state at the present time. India desperately needs a political leader who can look beyond partisanship at home to bring in a more productive era for the country's economy.

Guard against protectionism: It would be very easy for India to slip back into the mode of "import substitution" in an effort to protect the local industry and appease the voters. This policy can have long term detrimental effects on the economy.

Infrastructure incentives: Incentives aimed at attracting foreign investment in infrastructure improvement will help alleviate many of the country's current issues. Such capital-intensive projects would significantly increase foreign direct investment and help solve some of the country's most pressing problems. Due to the urgency of the matter, it may be prudent to consider launching targeted promotions and bonuses in this regard.

Foreign direct investment (FDI) outflows have taken a severe hit from the global economic downturn that began in 2008, and the European debt crisis is unlikely to assist matters. Indian businesses should be given special rules and incentives to help them expand into new international markets.

India's reputation relies on its capacity to combat corruption and create a secure, corruption-free environment for international firms to invest in and prosper.