

## Abstract

Like many emerging market economies (EMEs), India also experienced significant surge in capital inflows since the second half of 1990s. The capital inflows as percentage of GDP increased from 7.2 per cent during 1990-91 to 25.8 per cent in 2008-09 reflecting rising contribution of financial channel in India's global integration. Notably, the investment in India also made large leaps during the same period and generated an obvious debate on the contribution of capital inflows to the incremental investment. The relationship between investment and capital inflows based on national income accounting identity remains quite ambiguous on many counts. In view of above, we have attempted to investigate empirically the direct impact of capital inflows to investment in India in this paper. We have used the Johansen (1988) and Johansen and Juselius (1989) cointegration model to estimate the causality running from capital inflows to investment since data series used in the study viz., investment and capital inflows as percentage of GDP and GDP growth are of I(1) process. The estimates of the long run cointegration equation indicate that 37 per cent of the capital inflows go into higher investment. Variance decomposition analysis reveals that the contribution of KF to GDCF variation increases and reached to about 13 per cent by 10th period. We have found the short-term dynamics of the cointegration model quite robust with error correction mechanism (ECM) term negative and significant. ECM coefficient suggests that about 23 per cent of deviation in the long-run equilibrium level of investment is corrected in the next period.

**JEL Classification:** E22, F 34, F 36,

**Keywords:** Capital Inflows (KF), Gross Domestic Capital Formation (GDCF), Cointegration