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Foreign Direct Investment: An Analysis of Indian Economy

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ABSTRACT
In the recent years, significance of Foreign Direct Investment has been increasing especially in the developing countries. These countries are trying their level best to attract more and more FDI. Viewing this trend, the objective of this paper is to study the role of Indian Government to attract FDI and to analyse the trend to FDI inflows in the Indian economy. The paper also highlights the effects of FDI on host country.

KEY WORDS: *Foreign Direct Investment, Economic Growth, Government Policy, green field investment*

INTRODUCTION

Foreign direct investment takes place when a company invests directly in the production or marketing of a product in a foreign country. FDI is defined as an investment involving a long - term relationship that reflects the long - term interest and control of a resident entity in the host country (foreign direct investor or parent company). Foreign companies are directly involved in daily operations in the other country with FDI. This means that they do not only bring money, but also knowledge, skills and technology. The Economic Cooperation and Development Organization (OECD) defines control as owning 10% or more of the business. Businesses making direct foreign investments are often referred to as multinational corporations (MNCs) or multinational companies (MNEs). A MNE can make a direct investment by creating a new foreign company called a green field investment or by acquiring an foreign company called an acquisition or a brown field investment. The arguments supporting foreign direct investment includes limitations to exporting, management control, limitation to licensing, diversification and on the other hand FDI is restricted due to higher cost, political uncertainty, cultural differences and poor infrastructure facilities in the host countries

Literature Review

Dr. JasbirSingh, Ms. SumitaChadha, Dr. Anupama Sharma (2012) in their paper titled **"Role of Foreign Direct Investment in India: An Analytical Study"** argued that the maximum international investment flows are attracted by developed countries rather than developing countries and under developing countries. Foreign investment flows complement scare domestic investment in developing countries, especially India. They found that the highest amount of FDI went to the financing sector, insurance sector, real estate and business services, representing 33.05 percent of the total cumulative inflow of FDI in India during the study period. They remarked that India should welcome the inflow of foreign investment in such a way that it should be convenient and favorable to the Indian economy and enable it to achieve goals, such as rapid economic development, the elimination of poverty and a favorable balance of payments.

Singh S., Singh M. (2011) in their paper titled, "**Trends and prospects of FDI in India**" investigated the trend of FDI inflow to India, during 1970–2007 using time series data. This paper aims to study the reasons behind the fluctuations of FDI inflow in India and to investigate the cause of the fluctuations in FDI trends.

Agarwal G., Khan M. A. (2011),in their paper titled "**Impact of FDI on GDP: A Comparative Study of China and India",** found that 1% increase in FDI would result in 0.07% increase in GDP of China and 0.02% increase in GDP of India. They concluded that growth in China was more affected by FDI than growth in India.

Sarkar S., Lai Y. C. (2010), in their paper **titled "Foreign Direct Investment, Spillovers and Output Dispersion - The Case of India",** suggested that foreign investment affects the firms" output positively and significantly and Domestic companies are less productive in sectors with more foreign investment than in sectors with relatively small foreign direct investment.

Kulwindar Singh (2005) in his paper **titled "Foreign Direct Investment in India: A Critical Analysis of FDI from 1991-2005"**analysed that the government began haphazardly with the foreign direct investment in order to stimulate growth in the economy. Although, government was forced to liberalize cautiously, the understanding of foreign investment was lacking .A sectoral analysis reveals that while FDI is gradually increasing and has become a key to India's success, progress is vague. So the impact of India's reforms on policy environment is mixed. Industrial reforms have gone far, but they need to be supplemented with more infrastructure reforms, which is a crucial missing link

Jennifer Tobin, Susan Rose-Ackerman (2005) in their paper titled **"Foreign Direct Investment and the Business Environment in Developing Countries: the Impact of Bilateral Investment Treaties"** concluded that the relationship between bilateral investment treaties (BIT) and FDI is weak. BITs appear to have little impact on FDI in general. In addition, BITs have a positive effect on FDI flows in countries with an already stable business environment rather than encouraging greater FDI in riskier environments. Overall, BITs appear to have little positive effect on foreign investment or on the perception by foreign investors of the investment environment in low-and medium-income countries.

Maria Carkovic and Ross Levine (2002) in their paper titled **"Does Foreign Direct Investment Accelerate Economic Growth?"** concluded that FDI inflows have no independent impact on economic growth. Thus, while sound economic policies can stimulate both growth and the FDI, the results are inconsistent with the FDI's view of growth that is independent of other growth determinants

Magnus Blomström, Ari Kokko (1996) in their paper titled **"The Impact of Foreign Investment on Host Countries: A Review of the Empirical Evidence"** quoted that foreign direct investment can promote economic development in their host countries by contributing to productivity growth and exports. However, the exact nature of the relationship between foreign MNCs and their host economies seems to vary. It is reasonable to assume that the industry and policy environment of the host country are important determinants of the net benefits of FDI.

M.K. Dutta, G.K. Sarma in their paper titled "**Foreign Direct Investment in India since 1991: Trends, Challenges and Prospects"** said that ongoing initiatives, such as further simplification of rules and regulations, infrastructure improvements are expected to provide the necessary impetus for the future increase of FDI inflows. FDI inflows depend on domestic economic conditions, global economic trends and global investor strategies. Government is fully committed to creating strong economic fundamentals and a proactive FDI policy regime. Although FDI inflow to India has increased, regional distribution is found to be more unfair. To ensure a more equitable regional distribution of such flows, the central and state governments should adopt a concerted strategy for improving infrastructure and creating a sound economic and political environment. After all, a more transparent investment system will benefit India and ensure the future prospect of FDI inflows.

Despite of the several studies conducted on FDI, analysis from the perspective of Indian economy has not been done in depth. Hence, the gap for research is pertinent.

Objectives:

- To understand the concept of Foreign Direct Investment
- To determine the trends of FDI inflow in India and to analyse the reasons behind such trends.
- To analyse the effect of FDI on host country.
- To understand the role of government in promoting FDI.

Data collection &Research methodology

Research methodology is a way to systematically study and solve the research problems. The secondary sources is used for the proposed research .Exiting literature is studied carefully to understand and analyse the research problem .Different books, journals, newspapers and relevant websites are consulted in order to make the study an effective one. The study attempts to examine the Foreign Direct Investment from Indian perspective.

Trends of FDI Inflow:

India today receives large FDI inflows due to its robust domestic economic performance. India's attraction can be seen from the increase in FDI inflows to India as shown in Table 1 from 1980 to 2016. India's FDI inflows during the 1980s were very low –about $ 0.08 billion. Some of the main reasons behind this were the complex legal and constitutional framework, restrictive and close door FDI policy. FDI was permitted only in selected sectors subject to different conditions, such as domestic equity participation, local content requirements, export obligations and local R&D promotion. Such restrictive policies did not provide the FDI environment in India. Only a few foreign countries like the United States (US), the United Kingdom (UK), Japan and Germany have therefore invested in India. With the opening of the Indian economy in 1991, FDI politics underwent a significant change as part of the wider process of economic reforms. Foreign investment in most sectors was permitted in a gradual manner and restrictive conditions were relaxed. These measures motivated foreign investors from all corners of the world to India; and at that time the country became a strong economic player. From 1992 to 1997, FDI inflows in India continued to rise and peaked at $ 3, 62 billion in 1997. The FDI shows the cyclic trend in 1998 and 1999 because of several factors. These include the mild recession in the US and the global economy, the South - East Asia financial crisis, political instability and poor domestic industrial environment. The introduction of the Foreign Exchange Management Act (FEMA) in 1999 and the recovery from the South - East Asian crisis caused FDI inflows to increase. FDI inflows increased again to $ 5.48 billion in 2001 and reached $ 25.35 billion in 2007. Well-developed financial sector, strong industrial base and critical mass of well-educated workers raised India's FDI inflows at $ 47.10 billion in 2008 to the highest level. Although the adverse effects of the US financial crisis in late 2008, India's FDI inflows declined in 2009 and 2010, India succeeded in inviting significant inflows in 2011. With Modi's entry in 2014, which took another phase of FDI policy reforms, the confidence of foreign investors in India is revived. FDI inflows reached the highest level by the end of 2016–$ 44.49 billion.

Table 1: India's Global FDI Inflow trend, 1980-2016

Year	India's FDI In flows (in US$ Billion)	India's Share in Global FDI Inflows
1980	0.08	0.15
1981	0.09	0.13
1982	0.07	0.12
1983	0.01	0.01
1984	0.02	0.03
1985	0.11	0.19
1986	0.12	0.14
1987	0.21	0.16
1988	0.09	0.06
1989	0.25	0.13
1990	0.24	0.12
1991	0.08	0.05
1992	0.25	0.15
1993	0.53	0.24
1994	0.97	0.38
1995	2.15	0.63
1996	2.53	0.65
1997	3.62	0.75
1998	2.63	0.38
1999	2.17	0.20
2000	3.59	0.26
2001	5.48	0.80
2002	5.63	0.95
2003	4.32	0.78
2004	5.78	0.84
2005	7.62	0.80
2006	20.33	1.45
2007	25.35	1.33
2008	47.10	3.14
2009	35.63	3.02
2010	27.42	1.97
2011	36.19	2.31
2012	24.20	1.60
2013	28.20	1.98
2014	34.58	2.61
2015	44.06	2.48
2016	44.49	2.55

Source:http://unctadstat.unctad.org/wds/ReportFolders/reportFolders.aspx

India has now done well in global FDI inflows. India's share of global FDI inflows has steadily increased. In the 1980s India had a small share of approximately 0.15 per cent of global FDI inflows, in 1997 it increased to 0.75 per cent; in 2008 it reached 3.14 per cent and in 2016 it reached 2.55 per cent (see Table 1 above). The government has implemented several reforms in recent years to attract more FDIs. These include improving infrastructure, revising the law on land acquisition, reforming labor law and rationalizing the process of obtaining environmental clearances. The new government has instructed various ministries to cooperate and meetings are often held at central government level. However, it remains difficult for foreign investors to navigate India's bureaucratic controls and procedures to obtain the necessary clearances and approvals. It is therefore essential to improve the coordination of projects between States and the Central Government. The Indian Government should create a better infrastructure environment with an appropriate institutional framework, such as the dispute resolution mechanism, the independent regulatory authority, etc. India should work to increase FDI caps in FDI potential sectors and allow more sectors to undergo the automatic route to minimize investment hurdles in India.

Effects of Foreign Direct Investment:

➢ **Financial resources**:

Many large transnational companies have access to financial resources which supplement the domestic capital available and help to spur the rate of investment. It is good for countries where saving date is low.

➢ **Technology:**

FDI often carries with it the benefits of technology, which is crucial in economic development .Technology, may be incorporated either in production process itself or in the product. This is a significant advantage for less developed countries and which lacks the research and development resources and skills required to develop their own indigenous product and process technology

➢ **Management skills:**

Foreign managerial skills aquired through FDI may also produce benefits. Foreign managers trained in the latest mamagement technique can often help to improve the efficiency of operations in the host country

➢ **Employment effect:**

FDI faciliates the creation of jobs for directly and indirectly and. Direct employment is the result of foreign transnational companies creating jobs for local population as a result of increased investment. Indirect employment arise as a result of increased investment which is the result of increased consumption expenditure

➢ **Balance of payment Effect:**

FDI has four important BOP effects for host country establishment .The establishment of a foreign subsidiary result in one time capital inflow in the economy balance of payment account .If the FDI is a substitute for import of goods and services ,it improves current account balance .When the transnational company uses of foreign subsidiary to export goods and services to other countries, it improves current account balance of host country .FDI also leads to the repartition of profit and dividend ,adding to the income of the home country subsidiary

➢ **Competition and economic growth:**

The existences of competition among producers result in the efficient functioning of market. FDI in the form of green field investment results in creation of new enterprise, increasing the number of players in competition in domestic market and the long-term results include increase productivity, product and process innovation and great economic growth

Role of Indian Government in Promoting Foreign Direct Investment:

To promote Foreign Direct Investment (FDI), the Government has put in place an investment - friendly policy in which, except for a small negative list, most sectors are open under the Automatic Road for 100 percent FDI. In addition, the FDI policy is reviewed on a continuous basis to ensure that India remains an attractive and investor-friendly destination. The policy changes are made after intensive consultations with stakeholders, including apex industry chambers, associations, industry / group representatives and other organizations, taking into account their views / comments. The FDI policy applies across the industry and applies equally to the SME sector. Foreign investment in various sectors brings international best practices and technology leading to economic growth in India and provides much needed impetus for the manufacturing sector and job creation in India. In line with the policy of boosting the manufacturing sector and giving impetus to the' Make in India ' initiative, the Government has allowed a manufacturer to sell its product via wholesale and/or retail, including through automated e - commerce. The Government has issued guidelines for foreign investment in the sector to provide clarity to the e - commerce sector. In the e - commerce market model, 100% FDI is allowed under automatic route.

Some provisions have been provided for FDI in the retail trade sector to address the interests of the Indian SME sector. For retail trading of single brand products, in respect of proposals involving foreign investment beyond 51 percent, sourcing of 30 percent of the value of goods purchased, has been mandated to be done from India, preferably from MSMEs, village and cottage industries, artisans and craftsmen, in all sectors. With a view to benefit farmers, give impetus to food processing industry and create vast employment opportunities, 100 percent FDI under Government route for trading, including through e - commerce, has been permitted in respect of food products manufactured and/or produced in India. Some plantation activities including coffee, rubber, cardamom, palm oil and olive oil plantations have been opened under automatic route for 100% foreign investment. Additionally, 100 percent FDI is permitted under automatic route in completed projects for the operation and management of townships, malls / shopping complexes and business centers. Also, foreign investment up to 49 percent in the defense sector has been permitted under automatic road conditions. Additional portfolio investments and investments by FVCIs were allowed up to the authorized automatic road level of 49 percent. Foreign investment of more than 49 percent has been allowed by government approval in cases leading to access to modern technology in the country or for other reasons. Furthermore, the FDI limit for the defense sector was also applied for the manufacture of small arms and munitions covered by the 1959 Arms Act.

Conclusion:

Foreign direct investment (FDI) plays an important role in economic growth and development. It not only complements an economy's investment requirements, but also brings new technology, management expertise and foreign exchange reserves. FDI helped India achieve financial stability and economic growth by investing in various sectors. FDI has boosted the economic life of India. After liberalization of Trade policies in India, we can observe that the trend of FDI inflows has been rising continuously and it has reached the peak of $44.49 billion by the end of 2016.The factors contributing to such inflows includes Make in India projects, investment friendly environment, providing required infrastructure facilities, promoting e-commerce and implementing ease of doing business facilities. However, India still needs to work on its policies to overcome its FDI hurdles and to provide a transparent working environment.

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