the imports, the foreign exchange reserve, the domestic savings, sector wise and country wise FDI inflow, and the FDI outflow from India.

The seventh and final chapter “Summary of Findings, Suggestions and Conclusion” presents the final findings, suggestions and conclusion of the study.

CHAPTER II

REVIEW OF LITERATURE

2.1 Introduction

2.2 Review of Literature

2.3 Theories of FDI

2.4 Summary.
2.1 Introduction

This chapter deals with the review of literature, collected from various sources related to this study such as books, journals, annual reports of foreign companies and the like. The purpose of literature survey is to develop a deeper insight into the problem, to review the previous research undertaken on the related problem, and to identify the gaps in the previous researches. Sometimes this kind of study may also give ideas and new lines of approach to the mentioned research area. Related literature has been reviewed in-depth, so as to broaden the understanding of the selected problem.

2.2 Review of Literature

Mahatma Gandhi, the father of India once said “I do not want my house to be walled in on all sides and my wisoms shuffled. I want the culture of all the lands to be blown about my house as freely as
possible. But I refuse to be blown off my feet. I refuse to live in the houses of other people as, a beggar or a slave”. Quoted by B.S.Badla and Usha Bhate in their article entitled “FDI Emerging Scenario”.

Pandit Jawaharlal Nehru the first Prime Minister of India said once in his Parliament speech that “India is not shy of foreign capital and technology but it welcomes only in those areas where we are not capable of having these”. This means that the country has to be very cautious in inviting the Foreign Investment and there is a limit for the inflow of the foreign capital into India.” as found quoted by A.N.Agarwal in his book on “Indian Economy: Problems of Development and Planning”.

Kotrak (1983) in his paper entitled “Global Profit Maximization and the Export Performance of Foreign Subsidiaries in India” analyzed by using the data of the RBI survey on Foreign collaborations for the year from 1964-65 to 1969-70, the export performance of equity companies. There were 11 manufacturing sectors. Each was subdivided into three ownership types, Foreign Subsidiaries (FS), Foreign Minority Companies (FMC) and Indian Companies with Purely Technical

1. Dr.B.S.Badla and Ms.Usha Bhate “FDI Emerging Scenario” Yojana, October 2004, pp.21-27
Collaboration (PTC) with foreign companies and it was found that the propensity to export went up as the foreign equity shares increased.\(^6\)

Bornschier and Chase-Dunn (1985), in their research paper titled “Transnational Corporations and Underdevelopment”, considered that flows of foreign investment has short-run positive effects on the economic growth, but accumulated stock of foreign capital has a long-term retardant effect on the economic growth and is associated with greater income inequality.\(^7\)

Schneidar, Fredrich and Frey (1985) in their paper titled “Economic and Political Determinant of Direct Investment”, analyzed the determinants of the FDI in eighty less developed countries. They analyzed four different models (Economic, Political, Politico-economic and Amalgamated) explaining the flow of the FDI which were econometrically estimated and compared with export forecasts. Among the four, the politico-economic model was found to be the best. In


order to test the stability of the estimated parameters, the estimates were undertaken for three different years.\(^8\)

Das (1987) in his paper titled “Externalities and Technology Transfer Through Multinational Corporation: A Theoretical Analysis” utilized a price leadership model from oligopoly theory to analyze the transfer of technology from the parent firm to its subsidiary abroad. This analysis recognized that the domestic firms learn from the MNCs and become more efficient. This increase in efficiency among the domestic firms is assumed to be exogenous and therefore costless to them. It is also assumed that the rate of increase in efficiency of the native firms is positively related to the level of activities of the MNCs subsidiary. The larger the scale of operations, the greater the opportunities for the native firm to learn from it. The author concludes that the more benefits from the technology transfer from its parent company in spite of the leakage of knowledge in the host country, and host country benefits unambiguously. Thus, in spite of the free insights competing domestic firms gain, it is still worthwhile for the MNC to import better technology.\(^9\)


Froot and Stein (1991) in their paper titled “Exchange Rate and Foreign Direct Investment: An Imperfect Capital Market Approach” provides an empirical evidence of increased inward FDI with currency depreciation through simple regressions using a small number of annual US aggregate FDI observation. The author presents that an imperfect capital markets story for which a currency appreciation may actually increase foreign investment by a firm. Imperfect capital market means, the internal cost of capital is lower than borrowing external sources. Thus an appreciation of the currency leads to increase firm wealth and provides the firm with greater low cost funds to invest relative to the counterpart firms in the foreign currency that experiences the devaluation of their currency.\(^\text{10}\)

Froot and Stein (1991) in their study titled “Exchange Rates and Foreign Direct Investment - An Imperfect Capital Market Approach” examined the effect of exchange rates on the FDI with respect to change in the bilateral level of the exchange rate between countries and in the volatility of exchange rate. An appreciation of a firm’s home

country’s currency would lower the cost of assets abroad and would lead to actual increase in the foreign investment by a firm abroad.\textsuperscript{11}

Kogut and Chang (1991) in their paper “Technological Capabilities and Japanese Foreign Direct Investment in the United States” provided evidences to show that the Japanese firm acquisition of FDI in the US was motivated by accessing firm-specific assets, not necessarily due to internationalization of their own firm specific assets. These motivations may or may not be contradictory to internationalization motivation for the FDI. In addition, they pointed out that, there was evidence that firms that were lacking the R&D and advertising innovation related to their industry were the ones that were likely to engage in the FDI.\textsuperscript{12}

Wang and Blomstrom (1992) in their study titled “Foreign Investment and Technology Transfer, a Simple Model” found that: (i) Technology transfer from a parent company to a subsidiary was positively related to the level and cost efficiency of a domestic firm’s learning investment. (ii) The lower the subsidiary’s discount rate, the


more rapid the technologies transfer. The higher the operation risks—for example, political instability or low potential economic growth—the more reluctant foreign firms would be to transfer technology. (iii) Some technology transfer proportional to the size of the technology gap always took place irrespective of the subsidiary’s active learning effort. The less costly the technology spillover from the parent to subsidiary firms, the faster the technology transfer.\(^\text{13}\)

Wheeler, and Mody, (1992) in their empirical study titled “International Investment Location Decisions: The Case of US Firms”, indicate that, according to the market size hypothesis, the markets with large population size and/or rapid economic growth (as measured by real GDP per capita or its growth) tend to give multinational firms more opportunities to generate greater sales and profits and thus become more attractive to their investments. They have tried to determine the relative importance of these two explanatory variables and found that market size is more important for the developed countries, while per capita GDP for the developing countries.\(^\text{14}\)


Campa (1993) in his Research paper “Entry by Foreign Firm in the US under Exchange Rate Uncertainty”, found that greater exchange rate uncertainty increased the option for firms to wait until investing in a market depressing current FDI. The author examined the evidence for this using data on FDI into the US in the wholesale industry.15

Mortimore (1993) in his work “Flying Geese or Sitting Ducks?, Transnational and Industry in Developing Countries”, empirically examined the effects of the FDI in a four equation macroeconomic model containing investment, savings, growth, and current account equation for a sample of 16 developing countries by providing some new information on the direct and indirect effects of the FDI. The results had shown that the FDI did not provide additional balance of payments financing for a preexisting current account deficit. In examining its indirect effects, it had been observed that the FDI had a negative impact on national savings. On the other hand, when all the sample countries were taken together, the FDI had increased repression and trade distortions.16


Tsai (1994) in his Empirical Research Paper titled “Determinants of Foreign Direct Investment and Its Impact on Economic Growth”, found a positive relationship between GDP and FDI inflows. The higher GDP per capita implies better prospects for the FDI in the host economy and this is valid for market-seeking FDI. FDI will go to countries that pay a higher return on capital and conclude that GDP plays an important role to attract more FDI into an economy.\(^\text{17}\)

However Klein and Rosengren (1994), in their study, “The Real Exchange Rates and Foreign Direct Investment in the United States: Relative Wealth Vs. Relative Wage Effect”, confirmed that exchange rates depreciation increased the US FDI using various sample of US FDI disaggregated by country source and type of FDI.\(^\text{18}\)

Markusen (1995) in his paper titled “The Boundaries of Multinational Enterprises and the Theory of International Trade” examined the contribution of the FDI to the host country’s economic growth. The traditional argument is that an inflow of the FDI improves the economic growth by increasing the capital stock. Whereas the


recent studies pointed out that, the rate of the FDI as a channel of international technology transfer. The FDI enhances technological change through technological diffusion, for instance, because of international firms are concentrating in industries with a high ratio of R&D relative to sales and a large share of technical and professional workers. The MNCs are probably among the most technologically advanced firms in the work. At the outset, the FDI not only contributes to imports more efficient foreign technologies, but also generates technological spillovers for local firm.\(^{19}\)

Dunning’s Electric Paradigm Theory (1996) of ‘OLI’ – Ownership, Location and Internalization states that three TNC motives or a combination of these motives to conduct foreign investment. Firms have ownership of specific advantages which they want to exploit in other markets. Locations have specific advantage that the TNC want to exploit. Internalization is preferred by TNC over third party licensing to avoid spillovers.\(^{20}\)

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Blomstrom and Kokko (1997) in their study entitled “Regional Integration and Foreign Direct Investment”, found that, the nature of the impact of trade-related provisions on intra-regional FDI would be determined by the motive and nature of pre-agreement intra regional investment. The removal of trade barriers between the integrating countries can lower intra-regional FDI when it is mainly of a market -seeking or tariff -jumping nature. With lowered trade barriers, companies with high fixed costs may concentrate their activity in one country and serve the partner markets through exports rather than set up subsidiaries in each of them.21

Blonigen (1997) in his study titled “Firm-specific Assets and the Link between Exchange Rates and Foreign Direct Investment”, provides evidence for the firms that are lacking in the R&D intensity (or innovation) relative to their industry competitions are the ones more likely engage in FDI. The author explores the evidence that Japanese firm’s acquisition of FDI in the US was motivated by accessing firm-specific assets, not necessarily due to internalization of their own firm

specific assets. These motivations may or may not be contradictory to internalization motivations for FDI.22

Blomstrom and Kokko (1997) in their investigation on “Regional Integration and Foreign Direct Investment”, pointed out that, Extra-regional FDI may also be affected by the preferential trade stipulations of the RTAs in different ways. The RTAs may raise the fear of future protection for the external investors, inducing them to venture inside the area and earn the status of being insiders.23

Borensztein et al (1998) in their study titled “How does Foreign Direct Investment Affect Economic Growth?”, suggest that the effectiveness of the FDI depends on the stock of human capital in the host country. Only in countries where human capital is above certain threshold does the FDI positively contribute to growth. The FDI leads to growth via technology spillovers that increase factor of productivity. They concluded that, human capital could educate labour force and if


necessary new technology and management skills were to be absorbed.24

Findlay (1998), in his study titled “Relative Backwardness, Foreign Direct Investment and the Transfer of Technology: A Sample Dynamic Model” examined the relationship between the FDI and the technological change in backward region. The rate of technological progress in the advanced region was postulated to increase at a constant rate. The rate of technological diffusion to the backward country was assumed to depend on two factors. Firstly, the greater the relative disparity in development level between the backward country and the industrialized part the world, the faster was the catch up rate. The author put forward the hypothesis that the rate of technological progress in a backward region is an increasing function of the technology gap between it and the advanced region. Therefore, for a given amount of foreign presence, the larger the technological gap between the foreign and domestic firm, the larger the spillovers. Secondly, the author considers that the technological innovations are most efficiently diffused when there is personal contact between those with the knowledge of the innovation and those who adopt it. These considerations led to the ratio of technological changes in the backward

region increases in proportion to the extent to which it opens up to the FDI.\textsuperscript{25}

Bajpai and Sachs (1999) in their research paper titled “The Progress of Policy and Variations in Performance at Sub-national Level in India” outlined that overdependence on agriculture and regional disparities between developed and backward states had created a “bandwagon effect” and forced the FDI only in certain areas, segments, and sectors of the economy.\textsuperscript{26}

Guillaumount and Chauvet (1999) in their study titled “Aid and Performance: A Reassessment” pointed out the implications of including a measure of the ‘Vulnerability’ of the economic environment (economic uncertainty) in an aided growth regression. They constructed an index of a ‘good environment’ comprising four variables.\textsuperscript{27}

Chalapeti, Murthy and Ranganathan (1999) in their study named “Foreign Direct Investment in the Post Liberalization Period: An

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Overview” tried to examine the dimension of Foreign Direct Investment in the post liberalization period in India. For a long time India’s approach towards the FDI was governed by the multiple objectives of self-reliance, protection of national industry and entrepreneurs, import of select technologies and export promotion. As a part of the structural adjustment programme along with vividly dismantling of the industrial regulatory system, India sought to attract the FDIs with its special favour and persuasion. This paper sought to provide an empirical content to the development during the first seven years of liberalization in India.  

Nirmal Kumar Chandra (1999) in his working paper titled “FDI and Domestic Economy Neo-liberalism in China” explored the complexity of China’s FDI policy. Beginning with the size of the inflow and their distribution by different sectors, in the host region and from different countries, it went on to describe the changing policies and the new types of foreign firms that had emerged in the recent past. The author concluded that a critical look at official data suggested an

exaggeration of the stock of inward FDIs and an understatement of the FDI outflows, which was often misconstrued as capital flight.29

Smarzynska, B.K (1999) in his study titled “Composition of Foreign Direct Investment and Protection of Intellectual Property Rights in Transition Economies” stresses that the establishment of property rights – in particular intellectual property rights – is crucial to attract high technology FDI. If intellectual property rights are weakly protected in a country, foreign firms will undertake low technology investments, which reduce the opportunities for spillover effects and improvements of productivity of domestic firms.30

Sahoo (1999) in his study, “Foreign Direct Investment and Economic Development : A Firm Level Analysis of Manufacturing Sector in Post Reform India”, showed that foreign firms had somewhat higher export ratios than that of the domestic firms and less import


dependent and less capital intensive in the selected industries in 1990-94.\textsuperscript{31}

Bosworth and Collins (1999) in their comprehensive study titled “Capital Flows to Developing Economics: Implications for Savings and Investment”, provided evidence concerning the effect of capital inflows on domestic investment for 58 developing countries during 1978-95. They distinguished among three types of inflow: FDI, Portfolio investment and other financial flows (primarily bank loan). They found that an increase of a dollar in capital flows was associated with an increase in domestic investment of about 50 percent (both capital inflow and domestic investment are expressed as percentage of GDP). These results however, make significant differences among the different types of inflows. The FDI appears to bring about close to a one-for-one increase in domestic investment. There is no dissemble relationship between the portfolio inflows and the investment (little or no impact) and the impact of loans falls between the FDI and the Portfolio inflows.\textsuperscript{32}


Lensink and Morrissey (2000) in their research paper “Aid Instability as a Measure of Uncertainty and the Positive Impact of Aid on Growth” suggested that economic uncertainty was an important determinant of both growth and the productivity of investment. By economic uncertainty they referred to the tendency of some developing countries to be particularly vulnerable to shocks that had the immediate effect of reducing income and, if recurrent trend to reduce growth (that is, Constrain the ability of an economy to reach its steady state growth rate). These shocks may be external, such as terms of trade shocks or financial crises induced by the volatility of capital flows, or “act of nature”, like severe drought or floods, while the FDI tends to be less volatile than other private flows, it is possible that sudden changes in the volume of the FDI inflow can have a destabilizing impact on the economy.33

Athreye and Kapur (2001) in their paper “Private Foreign Investment in India : Pain or Panacea?” noted that, according to survey conducted in the early 1990s, almost half of the foreign investors did not transfer up-to-date technology to their Indian subsidiaries or joint venture partners as intellectual property protection was considered too weak. In the chemical industry, this figured most

prominently as a target of the FDI until the mid 1990’s, 80 percent of the foreign investors referred to this problem, which might have inhibited more favorable growth effects. They found that the MNCs were dominant in many sectors (electrical, chemical, rubber, aluminium, automotive components) even during the restrictive phase. Further, they found out that the foreign controlled firms had higher profit margin than the domestic firms throughout the period, possibly due to their technological strength and access to global marketing networks. The brand names also gave them clear edge over domestic firms.  

Blonigen (2001) in his paper on “In Search of Substitution Between Foreign Production and Exports” considers the issue that trade flows may be either finished that are substitutes for the product that would be produced by the MNE’s affiliate in the same country or intermediate inputs that would be used by the MNE’s affiliate to produce a finished product. The former situation would suggest a negative correlation between “trade” and “FDI”, whereas the latter would see a positive association between the two. The author uses the product level trade and FDI data for Japanese 10 digit Harmonize Tariff Systems (HTS) products in the United States to show that the new FDI

in the US by Japanese firms increase Japanese exports of related intermediate input for these products whereas the new FDI leads to decline in the Japanese exports of the same finished products.\textsuperscript{35}

McKinsy Global Institute (2001) in its study “India’s Growth Imperative”, showed that in sectors where competition was stronger, the FDI had a much more positive impact. The removal of the FDI restrictions in the automotive sector unleashed competition and investments, resulting in a threefold increase in productivity that translated into a threefold increase in output resulting in due to falling prices, and employment increase rose.\textsuperscript{36}

\textbf{Impact of FDI in the Indian Automotive Industry}

(index 1992-93 = 100)

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<thead>
<tr>
<th>Barriers removed</th>
<th>Labour Productivity</th>
<th>Output</th>
<th>Employment</th>
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<tbody>
<tr>
<td>-Licensing Abolished</td>
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<tr>
<td>-FDI allowed</td>
<td>100</td>
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<td>356</td>
<td>380</td>
<td>111</td>
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Chakraborty and Basu (2002) in their study “Foreign Direct Investment and Growth in India: A Co-Integration Approach”, explored the two way link between the FDI and the growth by using a structural


\textsuperscript{33} McKinsy Global Institute, 2001, “India’s Growth Imperative.” Mumbai.
co-integration model with vector error correlation mechanism. Using aggregate data for 1974-1996, they found that causality ran more from the GDP to the FDI. In the long run, the FDI is positively related to the GDP and openers to trade. Furthermore, the FDI plays no significant role in the short run adjustment process of the GDP.\textsuperscript{37}

Girma \textit{et al} (2002) in their article titled “Does Antidumping Stimulate FDI? Evidence from Japanese Firms in the UK”, pointed out that, lowering of non-tariff barriers within RTA may provide an incentive to extra-regional investors to set up operations inside the region. Evidence suggests that the elimination of the use of anti-dumping measures within the European Union motivated the Japanese to set up operations inside the EU.\textsuperscript{38}

OECD survey (2002) on “Foreign Direct Investment for Development: Maximizing Benefits, Minimizing Costs”, found that, the FDI affects the growth which is likely to depend on the economic and technological conditions in the host country. In particular, it seems that developing countries have to reach a certain level of development, in education and/or infrastructure, before they are able to capture

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potential benefits associated with the FDI. Therefore, the FDI seems to have more limited growth impact in technologically less advanced countries. The main result of the OECD survey is that there seems to be a strong relationship between the FDI and the growth.\(^{39}\)

Blomstrom and Kokko (2003) in their study “The Economics of Foreign Direct Investment Incentives”, found that, Policy makers and academician often maintain that the Foreign Direct Investment (FDI) could be a source of important productivity externalities for the host countries. In addition to supplying capital, FDI can be a source valuable technology and knowhow and faster linkage with local firms could help start an economy. However, despite the strong conceptual case for a positive relationship between economic growth and FDI, the empirical evidence has been mixed.\(^{40}\)

Hanson, Mataloni, and Slaughter (2003) in their empirical study titled “Vertical Production Networks in Multinational Firms”, found that, documents a tendency for the multinationals to concentrate production in low-wage countries.\(^{41}\)

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Clive (2003) in his paper on “Private Participation in Infrastructure in Developing Countries: Trends, Impacts, and Policy Lessons”, have pointed out that in almost all cases FDI had a largely positive impact on productivity (the key criterion for assessing long term economic performance) and on converge of the services. But ill-designed privatization process, contracts and regulation have often led to poor returns on investment or some cases to excessive returns. The financial and infrastructure sectors are tricky to regulate as quasi natural monopolies, but FDI is not to blame for government shortcoming.42

Loungani, et al (2003) in their study titled “The Role of Information in Driving FDI: Theory and Evidence”, employed a gravity model of bilateral FDI and Portfolio capital flows in order to explain the determinants of the mobility of the financial capital across countries. They identified three main categories of variables that significantly explain the FDI inflows in the data. First, there is a positive correlation between the industry specialization in the source countries and FDI flows into the destination countries. Secondly, the case of communication between the source country and destination country (as measure by telephone densities in each country) is found to

have positive effects on the size of the FDI flows. Third, countries with higher debt-equity ratios of publicly traded companies attract less FDI flows.\textsuperscript{43}

Srinivasan (2003) in his study titled “Indian Economy: Current Problems and Future Prospects” expressed skill intensive manufacturing has reduced higher growth in the manufacturing sector. Despite starting much ahead of China, the SEZ movement in India had not picked up and is currently shrouded in controversies. The sea ports are underdeveloped and underutilized. The FDI regime has been restrictive and not welcoming as is evident in higher tariff and taxes on the TNCs.\textsuperscript{44}

However, several studies are more in line with the ADB’s verdict that account for ‘trivial share’ of India’s exports. According to this study, the FDI accounts for about 3 percent of India’s export compared to 50 percent or more in various East Asian host countries.\textsuperscript{45}


Blonigen et al (2004) in their paper on “Tariff-Jumping FDI and Domestic Firms Profit”, express that trade production encourages FDI is folk wisdom for economist, the author research into this relationship has examining all US antidumping trade protection actions from 1980 through 1995, and find FDI responses to these trade actions (tariff-Jumping FDI) occurs only for firms with previous experience as MNCs. Most firms facing such trade policies (many from developing countries) have no such experience and do not respond with the FDI. Instead, these firms must face either significant antidumping duties or go through the costly process of raising US prices and requesting recalculations of the duties. Domestic firms experience a 3 percent increase in expected discounted profitability from anti dumping duties unless the foreign firms subject to the duties decide to tariff-jump in which case the domestic firms do not experience any increase.⁴⁶

Banga (2004), in his paper titled “Impact of Government Policies and Investment Agreements on FDI Inflows”, showed that regional trading agreements like ASEAN and APEC could influence

the FDI inflows into the region as the risks associated with the investments decline with greater regional integration.\textsuperscript{47}

Desai, \textit{et al} (2004), in their paper titled “Foreign Direct Investment in a World of Multiple Taxes” found evidences that indirect taxes have an effect on the FDI that is in the same range as corporate income taxes. The bilateral international tax treat on the FDI activity affects flow of the FDI in a significant manner. This literature has recently examined other related taxes beyond corporate income tax.\textsuperscript{48}

Durham (2004) in his study “Absorptive Capacity and the Effects of Foreign Direct Investment and Equity Foreign Portfolio Investment on Economic Growth,” finds that countries with better financial systems and financial market regulations can exploit the FDI more efficiently and achieve a higher growth rate. These studies argue that countries need, not only a sound banking system, but also a functioning financial market to allow entrepreneurs to obtain credit to start a new business or expand an existing one. The emerging literature on the FDI stipulates that the FDI’s positive impact on growth depends


on local conditions and absorptive capacities. Essential among these capacities is financial development. These results imply that countries should reform their domestic financial system before working on attracting FDI.  

Jaumotte (2004) in his study titled “Foreign Direct Investment and Regional Trade Agreements: The Market Size Effect Revisited” found that, the creation of RTA may stimulate virtual competition between the participating countries, driving them to improve their investment environment to the best available in the region. In addition, a larger market provides opportunities to firms to grow and become more competitive. This may lead to the creation of intangible assets and thereby stimulate more investment.

Razin, et al (2004) in their research paper titled “Fixed Costs and FDI: The Conflicting Effects of Productivity Shocks” emphasized the two fold nature of investment decisions. In the presence of fixed setup costs of new investment, a firm determines how much to invest according to the standard marginal productivity conditions. For this


decision, the setup costs play no role. But in the presence of fixed setup costs, the profits that are generated when the firm carries out the amount of investment called for by marginal productivity conditions may be negative. Therefore, the firm faces a decision whether to incur the setup cost and invest at all. Thus they concluded that the investment decision of the firm was two folded whether to invest at all and if so how much to invest.51

Wei (2004) in his doctoral dissertation on “Foreign Direct Investment in China” states that Chinese Diaspora which includes 50 million people living in Hong Kong, Taiwan, Macau, Singapore is attracted by the government by formulating preferential favourable polices in the SEZ’s. Policies such as giving three years tax holidays and reduced rates after that period have attracted diaspora.52

Wezel (2004) in his paper on “Foreign Bank Entry into Emerging Economics: An Empirical Assessment of the Determinants and Risk Predicted on German FDI Data”, found that the GDP per capita is not a significant determinant of the bank FDI, but they concluded that the lower the risk of financial crises, the higher the


likelihood of entry, implying that banks prefer countries with stable outlook.\textsuperscript{53}

Agarwal (2005) in his study titled “Foreign Direct Investment in South Asia: Impact on Economic Growth and Local Investment” pooled the data of five south Asia host countries, among which India figured prominently in the period 1995-96. The co-efficient of the FDI to the GDP ratio turns out to be negative, though not significant. However, this approach ignored that the FDI was endogenous. Moreover, the inclusion of exports as a right hand side variable might bias the coefficient of the FDI variable downwards to the extent that the growth impact of the FDI might run through export promotion.\textsuperscript{54}

World Economic Forum’s Chief Economist, Augusto and Lopez-Claros (2005), in their paper titled “World Economic Forum’s Indian Economic Summit” has stated that “an inadequate supply of infrastructure is rated by business as the biggest obstacle to operation in


foreign affiliates and improving basic infrastructure would drive up the FDI”.55

Blonigen, Ellis and Fausten (2005) in their paper titled “Industrial Grouping and Foreign Investment” stated that information plays an important role on FDI decision. The FDI requires substantial fixed cost of identifying an efficient location acquiring knowledge of the local regulatory environment, and co-ordination of suppliers. Thus, access to better information about some host countries may make FDI to that location more likely. The author finds an interesting avenue for investigating this hypothesis using information on Japanese industrial group called Keiretsu. Horizontal Keiretsu is a group of firms across a wide range of industries, typically centered on a main bank that owns significant shares in these firms. The author examined whether sharing of information on regular basis affects FDI choices. They find that, the investment by a firm in the same Keiretsu will raise firms probably if locating an investment in that same host country by about 20 percent.56

Chowdhury and Mavrotas (2005), in their research paper titled “FDI and Growth: A Causal Relationship”, find that, the FDI is an


important source of capital. It complements domestic private investment. It is usually associated with new job opportunities and enhancement of technology transfer and spillover, human capital (knowledge and skill) enhancement. It boosts overall economic growth in host countries. On the other hand, a number of firm-level studies do not lend support for the view that the FDI promotes economic growth.\textsuperscript{57}

Kamalakanthan and Laurenceson (2005) in their paper “How Important is Foreign Capital to Income Growth in China and India?” suspected that the FDI could not reasonably be considered an important driver of economic growth in India because its contribution to gross fixed capital formation had remained small. Moreover, some observers doubted that the economic reform went far enough to change the character of the FDI in India and thus, resulted in types of FDI that might have more favorable growth effects.\textsuperscript{58}

Karbasi et al. (2005) in their study titled “Impact of Foreign Direct Investment and Trade on Economic” found that, the contribution of FDI on economic growth was enhanced by its positive interaction


\textsuperscript{55} Kamalakanthan A and Laurenceson J (2005) “How Important is Foreign capital to Income growth in China and India?”
with human capital and sound macroeconomic policies and institutional stability.  

W Jos Jansen and Ad C J Stokman (2005) in their paper titled “Foreign Direct Investment and International Business Cycle Co-Movement” examined to what extent the rapid expansion of the FDI and the internationalization of production could be related to the phenomena of more synchronized business cycles. Both larger inward and outward investment positions may make the domestic economy more susceptible to economic disturbances abroad. They focused on the relationship between the bilateral FDI position and cross country business cycle pattern and analyzed the experiences of Canada, France, Germany, the Netherland, the UK and the US in the years 1982-2001 looking at the bilateral linkage of the six countries among themselves and with six other countries (Australia, Belgium, Italy, Japan, Sweden, and Switzerland) employing the measures of International output co-movement. They found strong and robust evidence for a link between bilateral economic relationship and bilateral business cycle

correlations, but multi co-linearity problem prevented a precise assessment of the respective contributions of trade and the FDI. 60

Bishwanath and Rashmi (2006) in their study titled “Impact of Trade Liberalization on Foreign Direct Investment in Indian Industries” found that the regions having greater involvement in international trade were able to attract greater amount of the FDI. 61

Narasimhulu and Irfana (2006) in their paper on “Trends and Pattern of FDI in India” analyzed and expressed their view that India had to welcome inflow of the FDI in such a way, which would enable us to achieve our cherished goals such as rapid economic development, removal of poverty, inter personal, and inter-regional disparities in the level of development and to achieve self-reliance and modernization of the country. 62

Velde and Bezemer in their study on “Regional Integration and Foreign Direct Investment in Developing Countries” found that, production sharing between the US and Mexico in the automobile


sector became possible. While the manufacturing of parts and components was concentrated in the US, labour-intensive assembly operations were transferred to Mexico. This resulted in a significant increase in FDI flows into Mexico. The Rules of Origin riders can also encourage the use of intra-regional inputs diverting extra-regional inputs, even if these were more efficient. This would also promote intra-regional efficiency seeking FDI.\(^{63}\)

Velde and Bezemer (2006) in their empirical study titled “Regional Integration and Foreign Direct Investment in Developing Countries” found that, investment provisions in the RTAs consist of rules on pre and post entry treatment, protection of the FDI and expropriation and dispute settlement mechanisms. These regulations liberalize the FDI flows by reducing/eliminating restrictions on the entry and ownership of foreign investors and by ensuring that they do not suffer in treatment in comparison with their domestic counterparts. The investment rules guarantee a predictable investment climate and enhance investors’ confidence on the legal and political milieu, particularly in low and middle income countries. The RTAs may have positive effects on the FDI inflows to the extent that the investment

\(^{60}\) Velde D.W., and D. Bezemer (2006), Regional Integration and Foreign Direct Investment in Developing Countries, Transnational Corporations, Vol. 15, No. 2 (August 2006).
provisions lower barriers and facilitate capital flows. Further they stated that, the type of regional grouping matters i.e. whether or not RTA included certain trade and investment provisions. Within a regional grouping, the position of countries within a region matters.64

Wei (2006) in his article titled “Local Corruption and Global Capital Flows” showed that a variety of corruption indices were strongly and negatively correlated with FDI.65

Baltagi et al, (2007) in their study titled “Estimating Models of Complex FDI: Are There Third-country Effects?” revealed that, RTA increases FDI up to by 78 percent among European countries.66

Gabaix and Landier (2007) in their paper titled, “Why Has CEO Pay Increased So Much?” reviles that the gross profit of a firm is the product of its exogenous size and the talent of its CEO. In labor market equilibrium, more talented CEOs are assigned to larger firms.67


Iihan Ozturk (2007) in his review paper titled “Foreign Direct Investment – Growth Nexus: A Review of Recent Literature” provided literature dealing with effects of FDI on growth. The author finds that free trade zone, trade regime, the human capital in the host country, financial market regulations, banking system, infrastructure quality, tax incentives, market size, regional integration agreement and economic/political stability are very important determinants for the FDI that creates a positive impact on overall economic growth. The author conclude that, consensus has been reached among academia and practitioner that the FDI tends to have significant effect on economic growth through multiple channel such as capital formation, technology transfer and spillover, human capital (knowledge and skill) enhancement and so on.\textsuperscript{68}

Mirsha (2007) in his paper titled “The Role of FDI in Economic Development of India “analyzed and pointed out that the FDI played a significant role in the process of economic development of India, but very often created confusion like possibility of debt trap, aggravation of the balance of payments problems, adoption of unsuitable model of growth, adverse effect on the rate of savings, political pressure, 

production of low priority goods and the like. A careful and planned use of the FDI would benefit the economic development of any developing country like India in the post liberalization era.69

Neary in his study on Cross-Border Mergers as Instruments of Comparative Advantage,” found that, the cross-border acquisitions are motivated by market power.70

On the other hand, Nocke and Yeaple (2007) in their study titled “Cross-Border Mergers and Acquisitions Versus Greenfield Foreign Direct Investment: The Role of Firm Heterogeneity,” considered cross-border acquisitions but analyzed the interaction between trade costs (which are absent in the present model) and the source of firm heterogeneity (mobile versus non-mobile capabilities).71

Son and Kakwani (2007), in their study titled “Global Estimates of Pro-Poor Growth’, World Development (2008),” examined the global estimates of pro-poor growth. The objective was to present a cross-country analysis of pro-poor growth in 80 countries through 237 growth spells, during the period of 1984-2001. The paper confirmed the


association between growth patterns and certain variables that the literature has identified as significant determinants of growth and inequality. To achieve this objective the paper has proposed a new measure of pro-poor growth that captures gains and losses of growth rates due to change in the consumption behavior.⁷²

Arti Grower Goswami in his paper titled “Welfare Implications of Outsourcing Verses FDI in the Host Country” found that under certain conditions, depending on the absorption capacity of the host country, elasticity of substitution in production and relative demands generated by the FDI and outsourcing for the factors of the production, outsourcing might lead to a higher level of the real GDP. Also the author found that efforts to increase skills in the host country is more likely to payoff under outsourcing relative to the FDI, since outsourcing values skilled labour more than the FDI.⁷³

Aradhna Aggarwal (2008) in their paper titled “Regional Economic Integration and FDI in South Asia: Prospects and Problems” found that, the regional integration has the potential to promote the economic development in individual countries irrespective of the size


and the level of the growth. This potential can be exploited only through a deeper form of cooperation. Regional cooperation, by promoting cross border investment, will offer in terms of size and capabilities to compete globally. Furthermore, it can help in raising efficiency and industrial restructuring. It is opportunities to firms, especially from the a big stride forward to forge deeper integration.\textsuperscript{74}

Aradhna Aggarwal (2008) in their paper titled “Regional Economic Integration and FDI in South Asia: Prospects and Problems” found that, the slow progress and modest achievements of regional integration in South Asia have generated significant skepticism about its role as an effective arrangement. However, the regional integration has the potential to promote economic development in individual countries irrespective of size and the level of growth. This potential can be exploited only through a deeper form of cooperation. Unresolved smaller countries, to grow essential that the South Asian countries take structural weaknesses, institutional bottlenecks, political movements, narrow nationalism and mutual mistrust are several factors that explain the failure of the region to tap its potential. These problems themselves provide strong motivation for strengthening cooperation. It is only through deeper regional collaboration that these shortcomings can be

\textsuperscript{71} Aradhna Aggarwal (2008), Regional Economic Integration and FDI in South Asia: Prospects and Problems, Working Paper 218, p. 33.
addressed and rectified. Increased investment flows will improve the competitiveness of regional firms in the global markets.\textsuperscript{75}

Tsai and Huang (2008) in their study titled “Openness, Growth and Poverty: The Case of Taiwan”, examined how the economic growth, openness and the role of government contribute to poverty alleviation in Taiwan using time series data during 1964-2003. The result revealed that the openness to foreign trade helps the poor through a direct distribution effect as well as indirect growth effect, in both long and short term. While inward FDI has no significant impact on the mean income of the poor, outward FDI from Taiwan in the past two decades seems to have had an adverse effect on the poorest 20% of the population.\textsuperscript{76}

Calderon \textit{et al}, (2008) in their study titled “What is the Impact of International Remittances on Poverty and Inequality in Latin America?” examined the impact of international remittances on poverty and inequality in Latin America. They used a large cross-country panel data set for 10 Latin America Countries (LAC) and found that

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\textsuperscript{72} Aradhna Aggarwal (2008), Regional Economic Integration and FDI in South Asia: Prospects and Problems, Working Paper 218 p.33.

\end{flushright}
remittances in the LAC countries have increased growth and reduced inequality and poverty.\textsuperscript{77}

Rutherford and Tar (2008) in their study titled “Poverty Effects of Russia’s WTO Accession: Modeling ‘Real’ Households with Endogenous Productivity Effects”, assessed the impact of accession to the WTO on income distribution and the poor in Russia. The model includes the FDI in services and Dixit-Sliglitz endogenous productivity effects in imperfectly competitive goods and services sectors. They employed a computable general equilibrium model for the Russian economy that reveals an incorporating the diversity of households though a real household model is important for assessing household impacts, but getting the key model features right is equally important.\textsuperscript{78}

2.3 Economic Theory of Foreign Direct Investment

i. Industrial Organization Perspective of FDI

The FDI theories note two kinds of market imperfections that may impede a contractual arrangement. One has to do with the structural imperfection of the market. These structural imperfections


can be a function of a number of industry characteristics, such as scale economics, R&D intensity, and a high degree of product differentiation, or they may be due to firm-level attributes, such as the kind of know-how and capabilities that are difficult to codify and transfer across different organizations. Firms derive market power from possessing these characteristics, and they exercise their market power more efficiently by internalizing production across different locations under the same ownership roof, when these firms expand into multinational territories on account of their market power, they become the MNCs. This reasoning is known as an industrial organization perspective of the FDI.

The second kind of market imperfections has to do with transaction cost. As noted by some theorists, the market power argument of the industrial organization perspective predicts certain firms will go abroad, but it does not predict why the MNC’s necessarily need to internalize operations and production sites scattered across different countries. The FDI is an ownership arrangement under which firms place geographically disposed activities under the same ownership. But these are other mechanisms MNC’s resort to in order to reap the benefits from the advantages they hold. They can, for example, sell or lease their assets to another firm; this is where the transaction cost perspective comes in. For one reason or another, these arm’s
length transactions are not viable because of the significant transaction cost involved.

ii. Modernization School Theory

This school includes the neoclassical (perfect market approach) Ownership, Location, and Internalization (OLI) paradigm, and Industrial organization theories (imperfect market approach). The neoclassical theory posts that free trade and free markets would lead to higher growth and increase the FDI flows, and that the developing countries will be able to grow through this channel by implementing the liberalization policies of the developed countries (natural order of development stage). The neoclassical theory stresses the link between free trade and FDI. The industrial organization theory argues that market imperfection (such as the existence of oligopolies) lead to horizontal or vertical integration, and hence FDI is more likely to take place in oligopolies. The OLI paradigm developed by John Dunning represents a mix of three distinct FDI theories. Each theory projects a different focus, the ‘O’ represents Ownership advantages. These are firms specific advantages that address the question of why go abroad. The ‘L’ refers to ‘Location’ advantages and addresses the issue of where should the MNC locates. Finally the ‘I’ refers to “Internalization” advantages and focuses on the question of how will
the firm go abroad?. The OLI paradigm is an electric theory of FDI that focuses on the FDI determinants from the perspective of the firm.

iii. The dependency school (dependencies / neo matrix and structuralist theories)

The neo matrix theory postulates that the repatriation of profit from developing countries worsens these countries’ terms of trade; and the structuralist theory claims that countries region on the periphery are marginalized since their resources are being exploited by prosperous centers. Thus, dependency theories view the FDI as a cause of increased spatial inequality in economic development within and across countries.

iv. The integrative school (Institutional Theories)

This school includes the bargaining theory, integrative theory, and “institutional FDI fitness” theory. The bargaining and integrative approach focus on the determinants of the FDI from the view point of both host countries and foreign investors. The institutional fitness theory, formally outlined by Saskin K.S. Wilhelms (1998) in an integrative theory that emphasizes macro, micro and meso-economic variables, where the meso-economic variables include institutions linking the host economy and the foreign firm. This theory focuses on the public and private sector interactions. In general, institutional theories focus on the FDI in developing economics and provide
analysis useful to researcher of the topics of economic growth and development.\textsuperscript{79}

\textbf{v. The Intervention / integration / Middle path theory}

The intervention or integrative school attempts to analyze FDI from the perspective of the host country as well as that of the investor. It incorporates arguments from both the classical and dependency theorists. The theory presents that foreign investment must be protected but only to the extent of the benefits it brings to the host state and to the extent to which foreign investors have behaved as good corporate citizens in promoting the economic and social objectives of the host country. The theory calls for a mixture of intervention (regulations) cautions against too much openness regulation or intervention. The theory recognizes that there are instances where market is better placed to act and other instances where government intervention is necessary. What is needed therefore is a balancing act between those activities that can best be handled by the market and those that can be done by the government.\textsuperscript{80}

\textbf{vi. Industrialization theory on FDI}


The FDI represents not simply a transfer of capital, but the transfer of a ‘package’ in which capital, management, and new technology are combined to be termed as industrialization theory of the FDI. The FDI entails a cross-border transfer of resources including, process and product technology, managerial skills, marketing, distribution know-how and human capital.81

vii. Dependency theory of FDI

According to this theory, Foreign Investment is harmful to the long term economic growth of developing nations. The theory asserts that first world nations became wealthy by extracting labour and other resources from the third world nations. Developing countries are inadequately compensated for their national resources. Global division of labour causes distortion, hinders growth, and increases income inequality. Hence, third world nations must develop independently without depending on foreign capital and goods. The dependency theory was adopted by various countries in the 1970s, most noticeably Latin American countries. A number of them adopted an import substitution strategy and demonstrated a hostile attitude toward foreign investment.

viii. Neo-classical Economic Theory of the FDI

The FDI contributes positively to the economic development and increases the level of social well being, because foreign investors are bringing capital into the host country, thereby influencing the quality and quantity of capital formation. Capital inflows and reinvestment of profits increase the total savings of the country and government revenue also increases through tax and other payments. The FDI replaces the inferior production technology by the superior one from advanced industrialized countries through the transfer of technology, managerial and marketing skills, market information, organized experience, and the training of workers. The FDI generates employment, influences income distribution and generates foreign exchange. Infrastructure facilities would be built and upgraded by foreign investors.

Review of literature on FDI has helped the researcher to identify the research gap. Studies pertaining to FDI inflow and its impact on industrial production in India are found to be inadequate, several aspects of the FDI such as trends and pattern, comparative analysis, location determinants of the FDI, impact of FDI on Indian economy received scanty attention especially during 1991-08. Therefore, the present study in some aspect is a follow up and also improvements over the other studies with extended period. Thus the present study on the role of Foreign Direct Investment in the Industrial Development in
India is not only an attempt to fill up the above mentioned research gap but also a valuable contribution to the existing knowledge about FDI and the new dimension to the role of FDI in the industrial production in India.

2.4 Summary

In this chapter, the researcher has reviewed various literature related to Foreign Direct Investment, growth, determinants, impact of FDI in various developed and developing countries, problems of FDI, FDI and host country’s economic policies, flow of FDI under the RTA condition, FDI and its behavior towards various components of the economy, and some of the theories related to FDI for the effective insight of the study in precious manner.

CHAPTER III

THEORETICAL BACKGROUND OF FDI AND PERSPECTIVE OF INDUSTRIAL DEVELOPMENT

3.1 Introduction

3.2 A Brief History of FDI

3.3 Definitions on FDI

3.4 Types of Foreign Investment