CHAPTER I

INTRODUCTION AND DESIGN OF THE STUDY

1.1 Introduction

1.2 Statement of the Problem

1.3 Scope of the Study

1.4 Significance of the Study

1.5 Objectives of the Study
1.1 Introduction

Capital formation through Foreign Direct Investment plays an important role in the development of an industry. In the absence of enough domestic saving, external capital plays a vital role in providing the much needed resources for adequate capital formation in the country. Foreign capital plays a significant role even when the country has sufficient domestic capital formation. The process of Industrial
development or production process requires not only capital but also some essential imported raw material. Sometimes, sophisticated technology or technical know-how, determines the productivity of capital, which may not be available within the country. Imported raw material, advanced technology, improved machinery, and technical know-how can be brought in, only by way of paying foreign exchange for such purchases. Development in export may not be sufficient to meet out the requirements of foreign exchange of the country. The requirements for foreign exchange gap and requirements of resources, technical know-how gap can be filled up only with the help of foreign capital.

The international financial market is also affected by the FDI flows. The FDI has emerged as the most important channel of external resources transfer to developing countries like India in the 1990s. The FDI had also acted as an agent of integration of economic activities across the countries in the 1990s. The FDI inflow had grown at an average annual rate of 20 percent over 1991-95 and at 32 percent during 1996-99. The FDI inflows are expected to be less volatile and non-debt creating. They are also expected to be accompanied by a number of other assets that are valuable for development, such as technology, organizational skills, and sometimes even market access among others. Perhaps the most prominent face of globalization is the
rapid integration of production and financial markets over the last decade; that is, trade and investment are the prime driving forces behind globalization. Hence the changes occurring in practically all countries in respect of the role of the state as economic regulator and owner have been observed. Expansion of the consumption demand component of GDP was surpassed by investment growth in the Asian region for the sixth consecutive year. This attributed to the positive outlook of investors and expectations of continued high rates of growth.\footnote{ADB, (2007) “Foreign Direct Investment in South Asia”, South Asia Economic Report, December 2007, p.3.} Privatization, Liberalization, and Deregulation are the driving forces of economic development in the last decade particularly for the globalization process. Private ownership, entrepreneurship and open door economy are the key important factors in most economies. Due to LPG process the Government of India has started inviting Foreign Direct Investment in the development of Indian industries.

“Liberalization of FDI Policy is expected to attract large FDI inflows in the development of infrastructure, technological upgradation of Indian Industry through green field investment in manufacturing, and in projects having potential for creating employment opportunities”, Shri Kamal Nath (Union Minister of Commerce & Industry) said.
The last two decades of the 20th century witnessed a marked change in the attitude of the most developing countries towards foreign capital, accompanied by a dramatic worldwide increase in Foreign Direct Investment (FDI). As against a highly suspicious attitude of these countries towards inward FDI in the past, most countries including some of the developed countries now regard the FDI as beneficial for their development effort and compete with each other to attract it. In the last decade of 20th century most of the countries changed their political and economic system in such a way to attract more and more FDI. Many countries abandoned socialism in its various forms and embraced the market economy. In many of the Eastern European countries, mass privatization has taken place mainly with the investment from abroad. Even many of the Asian countries including China, South Korea, Singapore, Thailand, and Malaysia are largely attributable to a high level of Foreign Investment and export promotion. India is one of the most transparent and a liberal FDI regime among the developing countries with strong economic fundamentals, but still suffers from weaknesses and constraints, in terms of policy and regulatory frame work.

Private Foreign Investment in developing and less developed countries is vast, complicated and controversial and also much speculative over the years. Hence, it has received less attention in terms
of data collection and analysis than any other form of economic development. The whole world now depends on private capital/foreign capital to a greater extent. The recent acceleration of flows of the FDI has received an interest in considering the Trans National Corporations (TNCs) as the engine of growth of developing countries particularly in India. The FDI is a vital requirement for sustained economic growth in India. It can generate employment in the host countries, in addition to supplementing domestic savings and helping meet the huge demand for investment. The FDI can also bring foreign currencies into the host countries by stimulating export of goods and services. Expectations of significant future domestic demand, especially in countries with large population such as India, can result in FDI from foreign companies establishing large production bases in the domestic market. Such FDI will expand product variety and consumer choices, and promote technology transfers and knowledge spillovers through forward and backward linkages in the host economies. In order to attract more FDI into India, the Government of India is liberalizing its economic policy continuously. In South Asia, India plays a dominant role in attracting the FDI, thus it could achieve 8 percent plus economic growth in the recent years. Though, the government offers more benefits to foreign investors, the inflows of the FDI again are very small compared to China. In this context, the present study analyses the determinants of
the FDI, the FDI impact on Indian economy in general and industrial development in particular.

1.2 Statement of the Problem

For a long period of time, the FDI was used by colonial power to exploit the Indian resources. The sector that received such investment was mostly used in export sectors, and this led to an enclave type of investment. Before liberalization, India was lacking significantly in capital, technology, skills and entrepreneurship. However, among the different types of international capital movement, Foreign Direct Investment has come to occupy a very important place in recent years. Hence most countries – developed as well as developing, compete among themselves in attracting the FDI inflows with increasingly liberal policy regimes and incentive packages.

But in India, there is a gap between the volume of the FDI approval and the actual flows (around 22 per cent) resulting in the much added pressure on Indian foreign exchange reserve for financing its development needs in general and its industrial need in particular. Therefore, it is necessary to analyze the factors that have impeded the inflow of the foreign investment. An analysis of the determinants of FDI inflow into India would help to fill up this gap between the actual and the approvals.
Foreign Direct Investment by facilitating imports of capital and technology, managerial skills and finance can play a leading role in the development of the industrial sector in developing countries. Therefore, it is necessary to examine the FDI and its impact in selected industrial sector.

The recent growth of the FDI flows has been fuelled by cross-border mergers and acquisition (M&A) like in North America and Europe as a part of ongoing wave of industrial restructuring and consolidation. Hence, most of the developed as well as developing countries compete among themselves in attracting the FDI inflows by various ways like joint venture, merger, acquisition and the like. Therefore it is necessary to analyze and compare the role of the FDI in India and in the other Asian countries.

Though, India attracts more FDI, still there is a problem of unemployment, industrial production, foreign exchange reserve, and the like. India’s contributions to world export remain small when compared to other developing countries in the world. According to UNCTAD survey, India is in the second position in the most attractive location for FDI. Even then, the inflow of FDI into India again very less and hence there is an urgent need to analyze the correlation between the FDI and export, and to study the growth in export after introducing FDI.
1.3 Scope of the Study

The present study aims to analyze some issues connected with the current FDI inflows into India. The study further analyzes the impact of the FDI on the growth of industrial development in India. These issues include impact and determinants of the FDI in selected industrial sector under the LPG framework. In order to explore the rationale and scope of further Government policy reform the study includes ownership control, inward flow of the FDI into India, sectoral trends in the FDI, channel of the FDI approvals, major the FDI suppliers and FDI flows into India and FDI in India and other Asian countries. The study also analyzes industrial development in India before and after the liberalization of Indian economy.

Through the FDI, the country can bring new technology, which generates benefits for both the host and the source country. The present study entitled “A Study on the Role of Foreign Direct Investment in the Industrial Development in India”, will offer suggestions to improve the FDI inflow for the overall development of Indian economy.

1.4 Significance of the Study

India is one of the developing countries which has introduced a liberalization policy and part of it has relaxed the FDI regulatory framework on selective basis with reference primarily to the industrial sector since 1991. The FDI plays an important role in Indian economy
and it is a non-debt creating long-term private capital. It also provides a stimulus to competition, innovation, savings and capital formation and enhances job creation, industrial growth and economic development. The economists believe that the impact of the FDI is positive, since it brings to the developing countries a package of capital, foreign exchange, technology, managerial expertise, skills and other inputs which are critical for the development on Indian economy. The FDI will improve the international equality in allocating capital.

Capital formation through Foreign Investment plays an important role in the development of industry. In the absence of domestic saving and capital formation, the capital of external or outside countries plays a vital role in providing the much needed resources for adequate capital formation in the country. In the modern process of industrial development or production process requires not only capital but also essential raw material, technical know-how, enhanced technology and the like. Hence, technical know-how and technology also determine the productivity of the country.

In recent decades almost all the countries (developed as well as developing nations) initiated to attract more FDI. It is because, some of the Asian countries like China, Thailand, Singapore and Korea increased their status among the world economy by using more foreign investment. Foreign Investment serves as a substitute for import and to
the outward export, many countries have widely recognized it as a tool for economic upliftment and an imperative input for sustained economic development. In this globalization process, the FDI has an unusual, very great importance in the Indian economy. India’s liberalization policy has evolved significantly by changing the attitude of the country from the protective tendencies adopted in the past to open door economy. In view of globalization process taking place with rapid development in various parts of the world, the question of attracting FDI for economic development in the emerging economies has come to in a sharp focus.

India has been starting to liberalize its economy since 1991 and it has relaxed the FDI regulating framework on a selective basis to industrial sector. Such a positive and open door policy followed by India towards foreign investment is in contrast to its an early restrictive approach. On the other hand, some economic and social thinkers criticize and are against foreign investor due to the bad experience during the British colonialism.

Through the FDI, the country can bring new production technology and other inputs from the host economy thus generating benefits to both the host and the source country. The liberalization policy is likely to continue in the coming years and the approach also changes its face towards the FDI. In this situation it is very urgent to
study the focus and importance of the Foreign Direct Investment from the direction of industrial development and growth, which will be useful to the nation to evaluate and implement suitable policy and approaches for the benefits of the economy in the forthcoming period. Further the study will offer useful suggestions to attract more FDI at the right time and to the right sector.

1.5 Objectives of the Study

The following are the objectives of the study:

i. To review the policies of the Indian Government towards the growth of the FDI.

ii. To review the inflows of the FDI into India.

iii. To examine the FDI and its impact on industrial performance in India.

iv. To study the determinants of the FDI and its impact on Indian Economy.

v. To analyze and compare the role of the FDI in India and other Asian countries.

vi. To offer suggestions to improve the FDI flow for the overall development of the Indian economy.

1.6 Hypotheses of the Study

The following are the hypotheses to be tested in this study:
i. There is a positive relationship between the FDI inflow and the industrial production in India.

ii. There is a positive relationship between the FDI growth and the Industrial growth rate.

iii. There is a positive impact of the FDI on India’s GDP, export and import.

iv. Indian economic development positively depends on the inflow of the FDI.

v. Increase in trade flows is associated with higher inflow of the FDI in India in the post reform period.

vi. India is attracting more FDI among Asian countries.

vii. Countries with better physical infrastructure and business friendly environment receive more FDI compared to others.

viii. Countries with higher per capita and higher GDP growth rate are with larger receipt of the FDI compared to those of the other economies.

ix. FDI and FII have positive relationship.

x. There is no significant difference between the inflows of the FDI and the FII.

xi. When the interest increases in the host country, it leads the inflow of the more FII and the decrease in inflow of the FDI vice-a-versa.
xii. The Average outward FDI over the time period and various sectors are equally distributed over the study period.

xiii. The inflows of the FDI from the various countries are equally distributed over the period.

xiv. The inflows of the FDI from the source countries to India are equally distributed to the various sectors over the mentioned period.

1.7 Sources of Data

This study has been carried out with the help of secondary data. The required secondary data for the analyses of the study were collected from published sources. The trend and pattern of the FDI based on annual approval and the actual FDI facts were collected from the monthly bulletins of the Reserve Bank of India (RBI). The other data which include Industrial production, Industrial growth rate, GDP and its index growth rate, domestic savings, capital formation, Foreign Institutional Investment, FPI, were taken from various handbook of statistics of Indian Economy, Economic Survey, various magazines, newsletters from SIA and from daily newspapers. The data related to global FDI inflow and outflow, mergers and acquisition, developing and developed countries, and Asian countries were taken from the annual publications of World Investment Report, Asian Development
Bank Report and reports from web sites of various official sources of the FDI details.

1.8 Period of the Study

The study uses FDI data and other related data for empirical analysis covering the period between 1990-91 and 2007-08, because from 1990-91 onwards India opened its economic door for foreign investors. Though the study uses some important data regarding foreign investment, economic parameters and industrial development before and after independence, due to lack of continuity in the availability of data regarding the various aspects of the study is a stumbling block in the analysis. Therefore the study has given much emphasis to the period from 1990-91 to 2007-08.

1.9 Operational Definition of Concepts

The operational definitions of concepts used in the present study are given below.

1.9.1 Foreign Investment

Foreign Investment refers to the acquisition of financial as well as real assets outside the home country. Financial assets include bank deposits, bonds and equity shares that do not give management control. Real assets include foreign means of production either fully owned or operationally controlled by investors through ownership of sufficient number of equity shares. Based on the time limit involved, financial
assets abroad can be classified into short term financial investments and long term financial investments (portfolio investment). Investment abroad in real assets is generally referred to as foreign direct investment.²

The term “Foreign Direct Investment (FDI)” and “Direct Foreign Investment (DFI)” are both in use in economic literature. Sometimes, the terms are used interchangeably in the same field of work, without making any conscious distinction. However, writers in the field stick to one of the terms and prefer Foreign Direct Investment. The international organizations also have preferred to use FDI in their publications.

The term “Foreign Direct Investment” has been framed from the recipient’s point of view, emphasizing more on the foreign nature. But the term direct foreign investment has been framed from the investor’s point of view, emphasizing that the direct investment concerned is directed outwards to the overseas market. The fact that more writers have used the term Foreign Direct Investment and this term reflects the recipient countries and more studies have been made from the recipient countries point of view.

Foreign Portfolio Investment (FPI) denotes passive holdings of securities and other financial assets, which do NOT entail active management or control of the securities’ issuer. FPI is positively influenced by high rates of return and reduction of risk through geographic diversification. The return on FPI is normally in the form of interest payments or non-voting dividends.

1.9.2 Exchange Rate

Exchange rate refers to the rate at which one currency can be exchanged for another.

1.9.3 Foreign Exchange Reserve

The nation receives is in currency of the foreign nation. All currencies other than the domestic currency of a given nation are referred to as the foreign exchange.

1.9.4 Globalization

This is the process of integration of the world into one huge market. This calls for the removal of all the political, geographical, and trade barriers among nations.

1.9.5 Gross Domestic Product (GDP)

GDP is the total market value of a nation’s output. It is the market value of all final goods and services produced within a given period of time by factors of production located within a nation. It is a key concept in the national income and product accounts. GDP, as a
measure of the total production of an economy, acts as an economic parameter of a nation.

1.9.6 Inflation

Inflation is a general rise in the prices in a persistent manner. It causes a loss in the purchasing power of a currency. It happens when many goods and services prices increase simultaneously.

1.9.7 National Income

National income is the total income earned by factors of production owned by a nation’s citizens. When output is produced, income is created. The income that flows to the private sector is called national income. It is the sum of five items, namely compensation of employees, proprietor’s income, corporate profits, net interest, and rental income.

1.9.8 Cross-border Mergers

Cross-border mergers occur when the assets and operation of firms from different countries are combined to establish a new legal entity. Cross-border acquisitions occur when the control of assets and operations is transferred from a local to a foreign company, with the local company becoming an affiliate of the foreign company.
1.9.9 **Greenfield FDI**

Greenfield FDI involves relocating an existing production division to country so as to allow the firm to deploy its corporate assets abroad. There are two countries that can freely trade with one another.

1.9.10 **Equity Capital**

Equity Capital refers to the foreign investor’s purchase of shares of an enterprise in a country other than its own.

Reinvested earnings comprise the direct investor’s share (in proportion to direct equity participation) of earnings not distributed as dividends by affiliates, or earnings not remitted to the direct investor. Such retained profits by affiliates are reinvested.

Other capital implies Intra-company loans or intra-company debt transactions refer to short- or long-term borrowing and lending of funds between direct investors (parent enterprises) and affiliate enterprises. Foreign direct investors may also obtain an effective voice in the management of another business entity through means other than acquiring an equity stake. These are also non-equity forms of investment, which include, inter alia like subcontracting, management contracts, turnkey arrangements, franchising, licensing and product-sharing.
1.9.11 Transnational Corporations

Transnational Corporations (TNCs) are incorporated or unincorporated enterprises comprising of parent enterprises and their foreign affiliates. A parent enterprise is defined as an enterprise that controls assets of other entities in countries other than its home country, usually by owning a certain equity capital stake.

1.9.12 Balance of Payment

A country’s balance-of-payments account is a record of a country’s payments to and receipts from other countries during the particular period.

1.9.13 GDR / ADR

A bank certificate issued in more than one country for share in a foreign company is called as Global Depository receipt (GDR). GDRs are the shares that are held by a foreign branch of an international branch. The shares are traded as domestic shares, but offers for sale globally through the various bank branches.

An American Depository Receipt (ADR) is a stock that trades in the United States but represents a specified number of shares in a foreign corporation. ADRs are bought and sold an American markets just like regular stocks, and are issued/sponsored in the U.S. by a bank or brokerage. ADR was introduced to the financial markets in 1927.
1.10 Frame work of Analysis

The present study analyzes the trends, determinants, relationship and impact of the FDI on the different aspects of the economy in India. Thus, the study used the following methodology to test various hypotheses set in this study.

i. Trend Analysis

One of the objectives of the study is to analyze the growth pattern of the FDI into India. For this, the following linear trend model was used.

\[ Y = A + BT \]

Where,

\[ Y = \text{amount of FDI} \]

A and B are constant to be estimated. B showed the linear growth in the amount of the FDI. T denotes time in years. This model gave only the linear annual growth of the FDI.

ii. t – test

Another important objective of the study is to examine whether the growth rates of various economic parameters differed between the two sub-periods of the FDI. The following t – test was used.
\[
t = \frac{(X_1 - X_2) - E(X_1 - X_2)}{SE(X)} = \frac{(\bar{X}_1 - \bar{X}_2) - (\mu_1 - \mu_2)}{\sqrt{\frac{S_1^2 + S_2^2}{n}}},
\]

Where, \( \bar{X}_1 \) is the mean of Sample 1,
\( \bar{X}_2 \) is the mean of Sample 2,
\( \mu_1 \) is the mean of Population 1,
\( \mu_2 \) is the mean of Population 2,
\( S_1^2 \) is the variance of Sample 1,
\( S_2^2 \) is the variance of Sample 2.

Here \( S_1 \) represented the slope coefficient obtained in the regression model, which was estimated for the pre-reform period and \( S_2 \) was the slope coefficient obtained in the regression model estimated for the post-reform period. SE is the standard error.

Interpretation – if the calculated \( t \) was > table \( t \) for \((n_1+n_2-2)\) d.f. then it indicates that the growth rate is statistically significant else insignificant.

iii. Correlation Method

Correlation is a statistical technique, which is used in measuring the closeness of relationship between the variables. The study analyses the relationship between the FDI and with the various economic parameters. The measure of correlation called the co-efficient of correlation denoted by symbol \( r \) and summarizes in one figure the direction and degree of correlation.


\[ r = \frac{\sum [(X - \bar{X})(Y - \bar{Y})]}{\sqrt{\sum (X - \bar{X})^2} \sqrt{\sum (Y - \bar{Y})}} \]

Where, \( \bar{X} \) = Mean of X observations, \( \bar{Y} \) = Mean of Y observations.

The following are the general guidance used to interpret the value of r.

i. when \( r = +1 \), it means that, there is perfect positive correlation between the variables.

ii. when \( r = -1 \), it means that, there is perfect negative correlation between the variables.

iii. when \( r = 0 \), it means that, there is no correlation between the variables. That is the variables are uncorrelated.

iv. **Regression Analysis**

The researcher used regression analysis to find out the relationship between two variables. In this study, simple regression is used to study the two variables, one variable (defined as independent) is the cause of the behaviour of another one (defined as dependent). To interpret the physical way in which independent variable X can affect dependent variable Y. the basic relationship between X and Y is given by

\[ Y = a + bx. \]
Where, \( Y \) denotes the estimated value of \( Y \) for a given value of \( X \). This is known as equation of \( Y \) on \( X \). which means that each unit change in \( X \) produces a change of \( b \) in \( Y \). which is positive for direct and negative for inverse relationships.

v. **Analysis of Variance (ANOVA)**

Analysis of variances (Abbreviated as ANOVA) technique is important in the situation, where the researcher wants to compare more than two populations. The essence of ANOVA is that the total amount of variation in a set of data is broken down into two types as that amount which can be attributed to chance and that amount which can be attributed to specified causes.\(^3\) There may be variation between samples and also within sample items. In order to analyze the various sources of variance, ANOVA consists in splitting the variances for analytical purpose. F-test is used to compare the variances by using the following formula.

\[
F = \frac{\text{Total Variance Between Samples}}{\text{Total Variance Within Sample}}
\]

Interpretation – this value of \( F \) is to be compared to the \( F \)-limit for given degree of freedom. If the \( F \) value is equal to or exceeds the \( F \)

\[^3\] Donald L. Hasnett and James L. Murphy, “Introductory Statistical Analysis”, p.376.
limit value, then there is a significant difference between the sample mean.

1.11 Limitations of the Study

The study is based on secondary data collected from various sources. It is very critical to apply and analyze some of the issues which is connected to this study in respect to the FDI inflow, the GDP, the Industrial development and other qualitative aspects. This study covered micro and macro aspects of the whole Indian economy and of the macroeconomic aspects of the Asian countries. Hence, it was not feasible to evaluate each and every aspect of micro macro comprises of economy.

In India, the aggregate FDI data according to previous method of calculation includes only the direct investment. Later in May 2002, RBI appointed a committee to analyze whether retained earnings and other long-term and short-term borrowings are to be included in the FDI. Data of such critical decision and not covered qualitative aspects such this research study considered various determinants and quantitative as political constraint, government approaches and social consideration and the like. Hence the study considered economic determinants and not other constraints.

This study considered only the FDI, the export, the import, the Industrial development, the GDP data and the like. It has the weakness
of lack of uniformity in the major policy reforms for such increase or decrease trends of those concepts. The researcher has not considered other sources of foreign investment like the Foreign Currency Convertible Bonds (FCCB), the ADR, the GDR, and the FII. Nowadays, these investments play an important role in the industrial development in India. The study has considered various micro and macroeconomic indicators at the national level on the whole, but not specific to state level. Appreciation / Depreciation of rupee in the international financial market has significant impact on the determination of the FDI, but this kind of market-floated rupee value has not been considered in this study.

1.12 Scheme of the Report

The research study entitled “A Study on the Role of Foreign Direct Investment in the Industrial Development in India” has been presented in seven chapters. The details of the chapters are as follows:

The first chapter, “Introduction and Design of the Study”, contains statement of the problem, scope of the study, significance of the study, objectives of the study, hypotheses of the study, operational definition of concepts, sources of data, period of the study, methodology, frame work of analysis, limitations of the study, and scheme of the report.
The second chapter entitled “Review of Literature” includes reviews of related literature and theories related to the FDI.

The third chapter “Theoretical background of FDI and perspective of Industrial development” highlights profile of brief history of the FDI, definitions, types of foreign investment, types of the FDI, FDI vs. Portfolio Investment, benefits of the FDI, Potential Pitfalls of the FDI, Industrial development in India, Foreign Investment during the British Government period, and industrial development in the post independence period.

The fourth chapter “Profile of the FDI in India and Asia” presents the details about Government policies towards the FDI, policy initiatives, the FDI in India, reasons for low FDI inflow, mergers and acquisitions, determinants of FDI, guidance to attract more FDI into India, and the FDI in Asia.

The fifth chapter “Analysis of the FDI pattern in India” evaluate the FDI approvals and actual inflow, the FDI and the FPI inflows, the FII in India, the FDI as per international practices, sector wise FDI inflow, foreign technology approvals, state wise FDI inflow, country wise FDI inflow, the FDI in Asia and in South Asia, green field projects in India and in China, and Exports from SEZ in India.

The sixth chapter “Analysis of the FDI and its impact on Economy”, includes the Industrial production, the GDP, the Exports,
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.