Chapter 1

Introduction
CHAPTER 1
INTRODUCTION

After the liberalisation regime of 1991, both inflows and outflows of capital from India have been rising on sustained basis. In particular, the sharp growth of Outward Foreign Direct Investment (FDI) from India has caught the attention of academicians, researchers and business houses alike. Till now, most of the theories of FDI examine the capital outflows from one developed country to another developed or developing country. The phenomenon of Outward Foreign Direct Investment (OFDI) from developing countries like India remains relatively unexplored till now. The extant theories of FDI emphasize and dwell upon the Firm Specific Advantages (FSAs) milked by Multi National Corporations (MNCs) from developed countries. However, these theories are based on firms from developed nations and are insufficient in explaining the surge of OFDI from developing countries like India, which inherently do not possess the similar FSAs as enjoyed by counterparts in developed countries. Further, the existing literature on OFDI from developing countries like India remains sparse and meager both at the macro and firm level, thereby requiring new theoretical underpinnings with respect to (w.r.t) developing countries like India.

In case of India, even the context, structure, magnitude and direction of OFDI has undergone tremendous changes owing to host of domestic and international factors. Through this research work, we seek to study, identify, measure and empirically postulate the drivers of OFDI both at the macro level and firm level from a developing nation like India. The main thrust of the work would be on examining, reviewing and testing the validity of the extant theories of FDI, with special reference to Ownership Location and Internalization (OLI) framework (Dunning, 1980, 1981) and Linkages Leverage and Learning (LLL) framework (Mathews, 2002 2006). We would seek to examine whether the present theoretical frameworks like OLI or LLL can sufficiently explain the new breed of MNCs from developing countries like India or China, or do we need an alternative framework as suggested by Buckley et al. (2007). To achieve this, we would identify the determinants of OFDI from India at the
Chapter 1  Introduction

macro level as well as at the firm level. For the firm level analysis, the empirical work would be built around OLI, LLL frameworks and the integration of these two frameworks. More specifically, we propose the modified version of LLL framework where ‘leverage’ would be depicted as the result of sustained linkages and learning over a long period of time. For the first time and especially in case of India we would propose the concept of leverage, measured by two variables i.e. Tobins Q and Debt Equity ratio. In India, there has been no published data on Tobins Q, therefore we would also be measuring and interpreting Tobins Q for the first time in case of Indian companies.

In the following section, we would throw light on background to the research problem, study the rationale of the research work, identify broadly the objectives to be achieved, provide brief description of the research hypotheses, specify the data sources and give brief account of research methodology.

1.1. BACKGROUND

During the last couple of decades, Indian Economy has attracted attention from rest of the world due to number of reasons. Amongst those reasons, the increasing economic prowess of India has been one of the significant reasons for its increasing international appeal. After the liberalization regime of 1991, our country has embarked upon new business avenues and also facilitated umpteen opportunities for other economies. Especially from the perspective of FDI, India has emerged as a major recipient due to its conducive business environment and investment friendly rules and regulations. The presence of MNCs in India, have played a pivotal role in altering the business environment at home as well as abroad. For long, world economy has been swayed by operations of MNCs from the developed countries. MNCs consider FDI as the preferred alternative amongst others\(^1\), to enter the foreign markets. FDI has been increasingly christened as an instrumental tool in alleviating poverty and bringing economic prosperity for developing countries. It is widely acknowledged that FDI is primarily carried out due to market imperfections and

\(^1\) A MNC can enter the foreign markets through number of entry modes like Joint Ventures, Technical Collaborations, wholly owned subsidiaries, affiliates, licensing and franchising. Among these alternatives, FDI provides management stake and control in the host country.
foreign firms must possess some sort of FSAs in order to compete in an alien foreign market (Hymer, 1960; Kindleberger, 1969; Caves, 1971; Aliber, 1970; Buckley and Casson, 1976).

Evolving form of business and increasing complexity of environment encompassing business necessitated various theories of FDIs\(^2\). Most of the theories of FDIs explained the outward investments by MNCs from developed countries. Such MNCs already possessed some technical and non-technical FSAs which were exploited by them in the host countries. Since the decade of 1960’s and especially during 1990’s MNCs started emerging from developing economies. Though literature is replete with various studies discussing the motives and impact of Outward FDI by MNCs from developed countries, little has been done with specific reference to emerging economies like India.

The topic of FDI inflows to India has been thoroughly researched and well documented. But during the last two decades, the topic of FDI outflows from India to rest of the world has created interest for academicians and business houses alike. The recent spate of large cross-border acquisitions (e.g. Tata Steel–Corus, Hindalco–Novelis, and Tata Motors–Jaguar/Land Rover, among others) and Greenfield investments by Indian companies have helped in focusing attention on the emergence of new corporate players on the global scene. Rising numbers and magnitudes of outward investments by Indian companies have made it an important and perhaps more dynamic aspect of increasing global economic integration of the Indian economy along with trade in goods and services and inward FDI (Kumar, 2008).

The overseas investment of domestic corporate sector through FDI has provided them better access to global network and markets, transfer of technology and varied skills. It has enabled them to share Research and Development (R&D) efforts and outcomes. This can also be seen as a corporate strategy to promote the brand image and utilization of raw materials available in the host country.

---

\(^2\) Among others, prominent theories of FDI’s include Vernon’s Product Life cycle theory, Kindleberger’ Oligopolistic Market Reaction theory, Hymer’s Market Imperfection theory and Dunning’s Ownership Location and Internalization theory.
India is now, the world’s twenty-first largest outward investor, which is significant considering its historically miniscule FDI outflows. India’s annual FDI outflows have jumped fifty-fold after 2000, and Indian firms have invested over US$ 75 billion overseas in the past decade, in some cases to attain global status by acquiring world-leading firms (Satyanand and Raghavendran, 2010). Substantial improvements in the country’s economic performance and the competitiveness of its firms and their strategy, resulting from ongoing liberalization in economic and Outward FDI policies, made these developments possible. Indian firms now invest across a wide variety of sectors and countries, departing from their historical focus on trading and textile investments in developing countries.

Indian firms began to invest overseas in the 1960s, but India’s restrictive OFDI regime limited them to small, minority joint ventures in developing economies. After 1991, intense domestic economic competition, the growing global competitiveness of Indian firms and liberalizations in OFDI and capital market policy triggered a rush of international investments by Indian companies, especially in the IT, pharmaceuticals, telecommunications, automotive, metal, and service sectors. In most of these sectors, Indian companies have sought to be global leaders.

We observe a remarkable change in the origin as well as respective choices of destination for foreign investments by MNCs from developed countries. Developing countries, which were earlier seen as host countries for investing abroad have now surged as home countries for overseas investments. Unlike the studies on FDI inflows to India, the number as well as the extent of studies on FDI outflows from India are limited and myopic (Pradhan, 2004 and 2008; Kumar, 2007 and 2008; Elango and Pattanaik, 2007; Kumar and Pradhan, 2007, Khanna and Palepu 2006, and Ramamurti and Singh, 2008). The present research work endeavors to fill the gap in the literature on Outward FDI from India, by analyzing the macro as well as the firm level determinants of Outward FDI.

**1.2. RATIONALE OF THE STUDY**

The relatively limited number of studies on OFDI from developing nations like India has drawn our attention to this research work in the wake up of sharp rise in OFDI
from India. Though, from time to time various studies have endeavored to ignite research interest in India’s capital outflows yet none of them could adequately explain the various drivers of OFDI from India both at macro level as well as at the firm level.

Further, the changing context of Indian economy in the globalized and interdependent world has also necessitated to carefully examine the structural overhaul in India’s overseas investment. As the world has undergone the new ways of doing the business, it is imperative to analyse to what extent the extant theories of OFDI can explain the growth of MNEs from developing country like India.

The miniscule number of studies on the motives of OFDI from India, especially in the wake up of new global paradigm has motivated us to undertake this research. The extant theories have primarily focused on MNCs from developed countries that already possessed competitive ownership advantages, which they capitalized in other developing or developed host countries.

Theories by eminent researchers like Hymer (1960), Kindleberger (1969), Caves (1971) and Dunning (1993) are largely oriented towards the dynamics of industrialized economies that ruled the world till late 1970s or so. As a result, their theories are insufficient in explaining the arrival of MNEs from developing countries especially from the Asian region since 1980s. The main research question that we are trying to unravel through this research work is to examine how the developing countries that were earlier the recipient of OFDI, emerged as the source of OFDI to the rest of the world. Further, we envisage to what extent this phenomenon can be explained by the existing theoretical framework, with special reference to OLI and LLL framework.

Further, whatever studies have been made, either focus on macro level or at the firm level without integrating these two from the perspective of the home country. This encouraged us to undertake empirically ascertain as well as determine the determinants of OFDI from India both at the macro level as well as at the firm level. This kind of research work will not only be unique but also will be carried out for the first time in case of developing nation like India.
More importantly, we seek to present a modified form of LLL model, where as opposed to Mathews (2002, 2006); we will be proposing leverage as the end result of linkages and learning, undergone by a domestic firm. Mathews has presented learning as the end result of sustained linkages and leverage by a local firm. While we propose the modified version of LLL framework, we also add to the existing body of knowledge by giving a new conceptual explanation to the concept of leverage.

Through this research work we attempt to link leverage to firm’s performance by using Tobins Q and Debt to equity ratio. The lack of published data on Tobins Q by Indian stock exchanges has further urged us to not only conceptually define but also measure and interpret Tobins Q in reference to a firm’s performance. No studies till now, has specifically endeavored to incorporate Tobins Q while determining the firm level drivers of OFDI from India during the post liberalisation period.

As some authors (Buckley et al., 2007) have also demonstrated that for developing countries like China, OLI and LLL model may not be sufficient to explain the phenomenon of OFDI from India, there is a need for new theory for such developing countries. These findings has led to further investigate whether OLI framework, LLL framework or synthesis of these two can work for explaining the surge of OFDI from developing countries like India or China or do we really require altogether a new framework for this phenomenon.

Further, the magnitude as well as the direction of Indian OFDI has undergone tremendous changes especially during the last decade. Now the focus of Indian MNEs is towards assets exploration through strategic linkages with MNCs from developed countries. The change in the geographical composition of OFDI from India has also drawn our interest to study the pull factors at the macro-economic level. Through our empirical work at the macro level, we also try to study the effects of global crisis on Indian OFDI.

The literature on Outward FDI from developing economies is limited and still there exists a knowledge gap in the literature on the question of choice of investment destination and motives behind investment, especially in the case of Indian MNEs. The lack of corporate statistics giving information on Outward FDI from India has
prevented such analysis; as a result it is of potential analytical and policy interest to examine the determinants of the Outward FDI activity of Indian enterprises.

With the help of this research, an analytical framework would be developed to assess the case of Indian MNC’s going for Outward FDI. It is of interest to examine the emerging trend, motivations, entry modes, and sources of strength or ownership advantages of the Indian MNC’s, in terms of the theory of internationalization of firms. More specifically we would be examining the determinants of OFDI at the macro and firm level with specific reference to the existing theoretical framework built around Dunning’s OLI and Mathews’ LLL framework.

1.3. OBJECTIVES OF THE STUDY

The study would undertake to achieve the following objectives:

1. To analyze the Trends and Patterns of Outward FDI from India especially during the post liberalization period,
2. To analyze the geographical as well as sectoral composition of Outward FDI from India,
3. To evaluate whether the existing literature on Outward FDI, can explain emergence of MNCs from developing countries like India,
4. To identify and analyze the various determinants that pull Outward FDI from India at the macro level,
5. To test whether OLI can be applied in its basic form to explain the increased presence of MNEs from India.
6. To examine whether LLL can replace OLI as another theoretical justification for the surge of Outward FDI from India.
7. To study whether the integrated form of OLI and LLL frameworks would be applicable in case of Indian overseas investments, and
8. To identify and examine firm level drivers, that pushes Outward FDI from India.

We would seek to accomplish the first two objectives, through chapter second where we would highlight the trends and patterns of OFDI from India meanwhile also discussing the evolutionary policy framework adopted by Indian Government. Third
and fourth chapter would be devoted toward explaining and completing objective mentioned at point three.

Chapter five will be designed to meet the fourth objective, where macroeconomic determinants of OFDI will be determined. For the last four objectives, i.e. objective number 5 6, 7 and 8, we would draw chapter number six, that would empirically postulate as well as test the validity of OLI framework, LLL framework and the Integrated model, composed of OLI and LLL framework, in explaining the growth of OFDI from developing nations like India.

1.4. RESEARCH HYPOTHESES

As we have mentioned in the above stated objectives, our empirical work will be carried out at the macro level as well as at the firm level, and accordingly we will be forming the respective research hypotheses at the relevant chapters. Still, broadly we can form the following hypotheses at the macro level:

1. $H_{0A}$: At the macro level Indian OFDI is not affected by economic variables.
2. $H_{1A}$: At the macro level Indian OFDI is affected by economic variables.
3. $H_{0B}$: At the macro level Indian OFDI is not affected by policy variables.
4. $H_{1B}$: At the macro level Indian OFDI is affected by policy variables.
5. $H_{0C}$: At the macro level Indian OFDI is not affected by economic meltdown during 2007-09.
6. $H_{1C}$: At the macro level Indian OFDI is adversely affected by economic meltdown during 2007-09.

While on the firm level, we can broadly form the following hypotheses:

1. $H_{0A}$: Ownership advantages do not affect OFDI from India.
2. $H_{1A}$: Ownership advantages positively affect OFDI from India.
3. $H_{0B}$: Locational advantages do not affect OFDI from India.
4. $H_{1B}$: Locational advantages positively affect OFDI from India.
5. $H_{0C}$: Internalization does not affect OFDI from India.
6. $H_{1C}$: Internalization positively affects OFDI from India.
7. \(H_0\text{D}\): Linkages with foreign partners do not affect OFDI from India.
8. \(H_1\text{D}\): Linkages with foreign partners positively affect OFDI from India.
9. \(H_0\text{E}\): Learning experience does not affect OFDI from India.
10. \(H_1\text{E}\): Learning experience positively affects OFDI from India.
11. \(H_0\text{F}\): Leverage of a firm does not affect OFDI from India.
12. \(H_1\text{F}\): Leverage of a firm positively affects OFDI from India.

However, we will be forming our research hypotheses more specifically in the chapters dealing with macro and firm level analysis.

1.5. DATA AND RESEARCH METHODOLOGY

Again as our empirical work will be accomplished at the macro level and firm level, we will be requiring different methodology and accessing different data from different sources respectively. For the Macro level analysis the data would be collected from United Nations Conference on Trade and Development (UNCTAD), World development indicators, Reserve Bank of India (RBI) and Department of Industrial policy and Promotion (DIPP). While the data for the firm level analysis will be compiled from Center for Monitoring Indian Economy, database called Prowess.

As far as the methodology is concerned we will be using tables, figures, descriptive statistics, and correlation matrix for showing the trends and patterns of Outward FDI from India. To determine the various macroeconomic drivers of OFDI from India, we will be employing Least Square Dummy Variable Model for fifteen countries for a period of ten years (2000-2009). The countries included are a mixed bag of developed and developing one, specifically they include-Singapore, Netherlands, Australia, USA, UK, UAE, Italy, Switzerland, Russia, Hong Kong, China, Cyprus, Canada, Brazil and France.

For the firm level analysis, we have employed Tobit model with Maximum likelihood ratio. As our dependent variable, i.e. OFDI intensity is a censored variable, the application of Tobit model appears to be more appropriate. We will be employing three estimating equations for the hypotheses testing. To assess the goodness of fit amongst the three estimating models, we will also be using Log Likelihood ratio.
1.6. CHAPTER SCHEME

The study would examine, in an evolutionary perspective, India’s OFDI and in its endeavor, the study besides tracing the emerging pattern of India’s Outward FDI, would assess the possible determinants of Outward FDI by the Indian enterprises, at the macro level and firm level respectively. The research work is spread across seven chapters. The first introductory chapter has been comprised of introduction, rationale for undertaking the study, objective of the study, brief account of research hypotheses and data and methodology. The second chapter would highlight the trends and patterns of Outward FDI by the Indian MNC’s in the post 1991 reforms period, along with the evolving Government policy regarding capital outflows.

The third chapter would consist of conceptual framework narrating the transition of theories of trade and FDI. The fourth chapter would reflect the literature review done w.r.t. OFDI from developing countries like India. The fifth chapter would undertake to empirically identify and assess the macroeconomic determinants of OFDI from India. This chapter would also simultaneously analyze and discuss the results from the hypotheses testing. While the sixth chapter would study and test the firm level determinants of OFDI from India, with specific reference to the existing theoretical framework. In the end of the sixth chapter we would also examine and elaborate the results from the hypotheses testing. The last chapter would summarize the study by drawing concluding remarks from each chapter, outlining the limitations of the study, along with requisite area for further research and policy recommendations. At the end of the seventh chapter we would provide the summary, contribution, limitations and concluding remarks w.r.t research work undertaken.