CHAPTER 1

INTRODUCTION
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1.0 The initiation of the process of planned economic development by the Government of India after independence is the most important event in the economic history of India. The Planning Commission was set up by the Government of India in March, 1950, and was made responsible for drawing up five-year plans aimed at attaining self-sustained economic growth within a few decades.

Growth is a function of Investment. With the objective of attaining a certain overall growth rate, the planners suggest a certain volume of investment. However, the economy consists of different sectors with variability in production techniques and capital output ratios. In order to arrive at a certain overall growth rate during a particular plan period, the different sectors must grow at certain different rates conformable with the overall growth rate as well as certain other socio-economic objectives, and the investments must be allocated to the different sectors accordingly. Investment depends on savings. The domestic savings at pre-plan rates of taxes, tariffs and administered prices of goods and services of public sector enterprises contribute towards financing investment expenditures. However, it is
seen that in the context of planning in India domestic savings always fall short of the investment needed for achieving the desired rate of growth.

Foreign capital supplements domestic savings for financing investment. The various forms under which foreign capital has been received are: external assistance or foreign aid which is a loan capital at soft or concessional terms, commercial borrowings or loans from international capital market, and foreign investment in the form of equity capital. While the former two are debt capital, the third one is a non-debt capital involving neither interest payment nor any obligation for repayment of the principal. Equity capital comes in two forms - one is portfolio investment and the other is foreign direct investment (FDI). While under portfolio investment investors usually invest in the shares of the companies motivated by short-term profit considerations, foreign direct investors make their investments in the establishment of production facilities being motivated by the long term prospects for making profits. The foreign direct investors add to investible resources and capital formation. This form of capital is also a means of transferring organizational and managerial practices, as also marketing facilities world-wide. While, portfolio investment does not result in a managerial control over the company whose securities are bought, FDI
usually results in managerial control over the operation of the foreign entity. Under this backdrop we intend to carry out empirically a research investigation in respect of growth impact of FDI in India in post reform period on sectoral basis. We also intend to analyse the impact of FDI on foreign exchange management of the country.

1.1 REVIEW OF LITERATURE

Many researchers throughout the globe have made empirical studies on the relation between FDI and economic activities in the host country. Below we review some such works.

In the earlier stage, a few studies held shown that FDI has a negative impact on the growth of the developing countries (Singer, 1950; Griffin, 1970; Weisskof, 1972). Singer argues that FDI has a detrimental effect on developing countries and leads to uneven global development. The main argument of these studies was that FDI flows to Less Developed Countries (LDCs) were mainly directed towards the primary sector, which basically promoted the less market value of this sector. Once these primary products are exported to the developed countries and are processed for import, it receives a lower price for its primary product. This could create a base for the negative impact of
FDI flows in the economy. On the other hand, Rodan (1961), Chenery and Strout (1996) in the early 1960s argued that foreign capital inflows have a favourable effect on the economic efficiency and growth towards the developing countries. It has been explained that FDI could have a favourable short-term effect on growth as it expands the economic activity. However, in the long run it reduces the growth rate due to dependency, particularly due to "decapitalization" (Bornschicr, 1980). This is due to the reason that the foreign investors repatriate their investment by contracting the economic activities in the long run. The studies that used the growth theory challenged this view in explaining the long run growth rate of the economy by using endogenous variables like technology and human capital (Barro and Martin, 1999). FDI is an important vehicle for the transfer of technology and knowledge and it demonstrates that it can have a long run effect on growth by generating increasing return in production via positive externalities and productive spillovers. Thus, FDI can lead to a higher growth by incorporating new inputs and techniques (Feenstra and Markusen, 1994).

In a study made by Chen, Chang and Zhang (1995), using time series data for the period of 1979-93, estimated the regression between GNP, domestic saving in one period lag, and FDI in one period lag (all
in logarithmic value). The results of the study show that there is a positive relationship between FDI and GNP and it is significant at 5 percent level for the Chinese economy. It is also supported by another study by Sahoo et al (2002). Hu and Khan (1997) attribute the spectacular growth rate of Chinese economy during 1952 to 1994 to the productivity gains largely due to market oriented reforms, especially the expansion of the non-state sector, as well as China's "open-door" policy, which brought about a dramatic expansion in foreign trade and FDI. Further, Bashir (1999) examined the relationship between FDI and growth empirically in some MENA countries, using panel data. The study found that FDI leads to economic growth; the effect, however, varies across regions and over time. Xu (2000), by using panel data has investigated the U.S. MNEs as a channel of international technology diffusion in 40 countries from 1966 to 1991. This study found a strong evidence of technology diffusion from US MNEs affiliated in developed countries (DCs) but weak evidence of such diffusion in the less developed countries (LDCs). The result for the DCs indicates that US MNEs are almost as important as international trade for technology spillover. Nearly 40 per cent of the total factor productivity (TFP) of DCs is attributable to the technology transfer of US affiliates. Further, the study also found that the level of human
capital is crucial for a country to benefit from technology spillovers of MNEs. A country needs to achieve a human capital threshold of about 1.9 years (in terms of male secondary school attainment) to benefit from the technology transfer by the MNEs. The results are consistent with the findings of single country study that the technology spillover effects of MNEs are positive in advanced countries but are insignificant in less developed countries.

India's neighbours that are relying heavily on FDI, such as China, Indonesia, Malaysia, and Thailand, have been pulling far ahead of India in economic growth, income levels and productivity, while also increasing their security and geopolitical influence in the world community. According to *World Investment Report 2003* (UNCTAD), "Foreign Investors regard both China and India as a hub for relocation of labour intensive activities. In India, the relocation has been confined to the services, particularly information and communication technology. In China, about 2/3rd of FDI flows into a diverse range of manufacturing industries."

Pradhan Java Prakash (2003), while empirically verifying the role of FDI in the growth process of developing countries found that the growth effect of domestic investment is relatively more sensitive
than FDI to the level of human development. For developing countries with higher human development the impact of domestic investment on growth is not only positive but also statistically significant, whereas, it has no significant impact in the case of developing countries with lower human development. The study found that the international linkages have a major role in the growth process, if the country has a lower human development than a country with a higher human development.

The research paper of Shalini Sharma and Ruchi Sharma (2003) developed two alternative econometric models to examine the degree of relationship between FDI inflows and GDP. The study used the data of 29 countries and provided an empirical base to the hypothesis that FDI is related directly to development, as measured by income, in order to provide a scientific base to the oft-repeated commonsense speculation about the role of FDI in development. But no evidence was found to support the hypothesis that the rates of growth of GDP and FDI are related.

The study of Nawal Kisor (2001) expressed that FDI has helped in accelerating the economic growth of many countries. According to the study, the importance of FDI is more in case of developing
countries, which require capital, technology and better management for faster economic growth.

The studies on FDI and economic growth in Indian are very limited. A study by Banga (2005) demonstrates that FDI, trade and technological progress have differential impact on wages and employment. While higher extent of FDI in an industry leads to higher wage rate in the industry, it has no impact on its employment. On the other hand, higher export intensity of an industry increases employment in the industry but has no effect on its wage rate. Technological progress is found to be labor saving but does influence the wage rate, the results show that domestic innovation in terms of research and development intensity has been labour utilizing in nature but import of technology has unfavorably affected employment in India.

The study by Dua and Rashid (1998) for the Indian economy does not support the unidirectional causality from FDI to Index of Industrial Production (IIP), where IIP is taken as the proxy for GDP. In fact, this study used the monthly data for IIP and GDP, which may include seasonal component in its variation and hence it is required to de-seasonalise the data. Alam (2000) in his comparative study of FDI
and economic growth for Indian and Bangladesh economy stressed that though the impact of FDI on growth is more in case of Indian economy yet it is not satisfactory. Sharma (2000) used a multiple regression technique to evaluate the role of FDI on the export performance in the Indian economy. The study concluded that FDI does not have a statistically significant role in the export promotion in Indian Economy. This result is also confirmed by the study of Pailwar (2001) and the study also argues that the foreign firms are more interested in the large Indian market rather than aiming for the global market.

A study on "Impact of foreign direct investment on Indian economy since economic liberalization" by Mohd. Firoz Alam (2005) reveals that the FDI is an important avenue through which investment takes place in a country. The importance of FDI extends beyond the financial capital that flows into the country.

None of the above studies relates to the role of FDI at the sectoral level in Indian economy. In fact, the study on the role of FDI at the sectoral level is very limited. We have come across one research investigation made by Dr. Mathai K. Mathiyazhagan, a Research Fellow at the Institute of South Asian Studies, an autonomous research
institute within the National University of Singapore. His paper entitled "Impact of Foreign Direct Investment on Indian Economy: A Sectoral Level Analysis" was published as ISAS (Institute of South Asian Studies) working paper (No. 6- Date 17 November, 2005). In this paper he tried to examine the impact of FDI at sectoral level in case of Indian economy by using a new technique called panel co-integration (PCONT).

We have reviewed above some well-known works done on FDI. None of the works we have come across exactly resembles the research work undertaken by us. As such we expect that our research investigation will add something new to the existing works on FDI.

1.2 ORIGIN OF THE RESEARCH PROBLEM:

India’s policy towards FDI or 'Foreign Collaborations' has gone through different phases. It has been evolved from a brief period of 'open door' in the fifties, to a policy of rigorous selectivity in the late sixties and seventies, to a policy of partial liberalization in the late eighties and to an open door policy in early nineties. The industrial policy resolution -1991 started a new phase of FDI in India. The roll of FDI is recognized on the ground that it would bring greater
competitiveness and efficiency into the system through modernization and technological upgradation.

Even since the concept of globalization has gained its popularity it has become imperative for countries to follow a policy of promoting trade and investment for internal growth and external participation. Cost effectiveness has compelled countries to restructure investment policy so as to embrace more capital inflows in the form of foreign direct investment. Consequent upon India signing the WTO agreement coming into effect from the 1st January, 1995 the country needed a total transition and a thorough restructuring of its industrial and economic base. The country's exports have to make a quantum jump; employment opportunities required a commendable acceleration the quality of manufactured goods needed to be standardized, the country had to be exposed to international competition, the internal prices had to be stabilized along with its corresponding control over its cost component, and the standard of living of the people had to be raised, to swim abreast of, if not ahead of other leading nations.

The role of FDI in accelerating India's economic growth through restructuring of its industrial and economic base by inducing foreign technologies is of paramount importance. Although domestic savings
have largely fuelled India’s economic growth yet we need foreign investment to supplement domestic savings in order to achieve the desired rate of growth. Recently Prime minister Dr. Manmohooan Singh told business leaders. That India would need $1.5 trillion in the next five years to sustain a GDP growth of more than 8 percent, of which $70 billion should be FDI.

Careful management of FOREX reserve is necessary in order to ensure stability of the currency. FDI would bring in hard currency which will be exchanged through Rupee currency. This would cause increase in velocity of currency and money supply. The RBI has to intervene to maintain inflation rate and stability in interest rate and other macro and micro-economic parameters of the economy. Purchasing power parity of the currency has to be maintained. Dividends pay out and repatriation of dividend income by the foreign institutional investors has to be looked into.

The reverse repo is the instrument through which the RBI mops up excess liquidity from the banking system, while the repo helps inject cash into the system.
1.3 INTERDISCIPLINARY RELEVANCE:

The investigation is of such a nature that it warrants an interdisciplinary approach. In order to materialize the objectives of the study stated subsequently econometric regression models and ordinary least squares (OLS) techniques are used which require knowledge of mathematics and statistics. Besides, data collection are done from the corporate enterprises with the investigators from commence background. For pursuing research investigation on the topic a good knowledge in economics of development and planning is essential. Thus the interdisciplinary integration is very much essential for carrying out research investigation on the topic.

1.4 INTERNATIONAL AND NATIONAL STATUS:

The studies undertaken by a number of international organizations have highlighted the attractiveness of India as an investment destination. At Kearney FDI confidence index, 2004 rated India as the third most attractive FDI destination. Besides UNCTAD found India along with the USA and China to be the top three investment hot spots. World Banks study had placed India among the top ten reformers in 2003 and in a recent survey industry body FICCI
found that 77 percent of foreign companies were making profits and another 9 per cent were breaking even.

The new foreign trade policy of India unveiled on April 7, 2006 focused mainly on attracting Foreign Direct Investments (FDIs) and generating employment for the youth. It is expected that after the new policy came into effect there would be 75 per cent growth in FDI and the exports would rise up to 100 billion dollar mark. India's foreign policy which was re-oriented a few years ago, has been changed from a more dollar-generating orientation to one which has thrust on employment generation and increase in overall economic activity. The FDIs in India are largely ‘domestic market driven’. The Minister for Commerce and Industry Kamal Nath said in Ahmedabad on April 7, 2006 that incremental exports created at least two-and-a-half-million new jobs in the past two years and such growth contributed significantly to the current boom witnessed by the Sensex.

1.5 SIGNIFICANCE OF THE STUDY:

The study is relevant and significant in respect of appraising as to the extent to which FDI has helped attaining a certain overall level of economic growth of the nation and the growth of various sectors of
the economy; the extent of jump in FOREX reserve contributed by the 
FDI and also to look into the counter measures adopted by the finance 
Ministry and the RBI jointly to check the eventual adversity that might 
occur when the FII’s repatriate their investments from rupee currency 
to hard US currency.

1.6 OBJECTIVES OF THE STUDY:

Some major objectives of the study are as follows:

a) To analyse statistically the impact of FDI on the growth of Indian 
   Economy;

b) To make a comparative study of the role of foreign and domestic 
   firms across different industries in augmenting development 
   process in post-reform India;

c) To analyse FDI in certain select sectors in recent period;

d) To study the overall impact of FDI on the foreign exchange 
   reserve of India to address the various problems of foreign 
   exchange management resulting from FDI;

e) To make a comparative study of growth impact of FDI and EA 
   (External Assistance).
1.7 SOURCES OF DATA AND METHODOLOGY OF STUDY:

Because of the nature of the problem the entire study is conducted on the basis of secondary data. The requisite data are collected from the following sources:

a) Planning Commission, Govt. of India (G.O.I.);

b) G.O.I., Economic Survey - Various Issues;

c) Basic Statistics Relating to Indian Economy, Centre for Monitoring Indian Economy, Bombay - Various issues;

d) Report on Currency and finance, Reserve Bank of India, Bombay - Various issues;


f) Central Statistical Organisation (CSO);

g) Company profiles of various companies.

We have made an empirical study of the impact of FDI on Gross Domestic Product (GDP) in the context of Indian economy with the help of the following simple linear econometric model:

\[ Y_i = \alpha_0 + \alpha_1 X + U_i \]
where, \( Y_j \) = GDP, \( X_j \) = FDI, \( a_0 \) = Intercept, \( a_1 \) = Impact of FDI on GDP, \( U_j \) is a random real variable that follows normal distribution.

In order to compare the growth impact of FDI with external assistance we have made use of the following multiple linear econometric model:

\[
Y_i = a_0 + a_1 X_1 + a_2 X_2 + U_i
\]

where, \( Y_i \) = GDP

\( X_1 = I_{FDI} \) (Investment Financed through Foreign Direct Investment)

\( X_2 = I_{FEA} \) (Investment Financed through External Assistance (EA) or Foreign Aid)

\( U_i \) = Stochastic disturbance term.

\( i = i^{th} \) observation,

\( a_0, a_1, a_2 \) are parameters to be estimated, \( a_0 \) is the intercept, \( a_1 \) measures the growth impact of investment financed through FDI and \( a_2 \) measures the growth impact of investment financed through EA.

So far as the comparative study made in respect of the role foreign and domestic firms across different industries in Post-reform
India is concerned, the methodology is described in the relevant chapter.

1.8 RESEARCH QUERIES TO BE ENCOUNTRED:

Some of the research queries we have encountered in our research investigation are as follows:

1. Whether there is a significant impact of FDI on the growth of Indian Economy or not;

2. Whether there is any significant difference between the performance of the domestic and foreign firms in respect of the parameters like export orientation, import dependency, capital intensity, profit intensity, vertical integration, product differentiation and effective tax rate or not;

3. Whether the overall impact of FDI on foreign exchange reserve is positive and significant or not;

4. Whether the growth impact of FDI is more prominent than that of external assistance or not;
5. Whether foreign firms contribute more to the economic growth of India in comparison to domestic firms or not.

1.9 PERIODICITY OF THE STUDY:

The flow of FDI to India prior to the opening up of the economy in mid 1991 was very insignificant. Hence our study relate to the period from 1991-1992 to 2009-2010.

1.10 LIMITATION OF THE STUDY:

All the economic / scientific studies are faced with various limitations and this study is no exception to the phenomena. Some of limitations of the study are:

1. At various stages, the basic objective of the study is suffered due to inadequacy of time series data from related agencies. There has also been a problem of sufficient homogenous data from different sources. For example, the time series used for different parameters, the averages are used. Therefore, the statistical tests used to measure the comparative growths may
deviate from the actual result. Moreover, the study lies under statistical errors.

2. The models used to depict the relationship among different variables are considered to be of linear type. But in reality the relationships may not be exactly a linear type.

3. To study the company wise inflow of foreign capital with respect to certain parameters in selected companies we prepared a questionnaire and sent it to the selected 50 companies. But, due to non-response of the companies we could not study the impact of FDI in respect of these companies.

1.11 CHAPTER SCHEME OF THE STUDY:

The thesis contains the following chapters;

Chapter 1: Introduction

Chapter 2: FDI Inflows as a supplement to domestic capital base

Chapter 3: FDI Inflow in select sectors: A periodical insight
Chapter 4: Impact of Foreign Direct Investment on the Growth of Indian Economy – An Empirical Evidence

Chapter 5: A Comparative Analysis of the Performance of Domestic and Foreign Firms in the Manufacturing Sector in Post-Reform India

Chapter 6: Foreign Inflows of Capital and Foreign Exchange Management

Chapter 7: Summary of Chapters, Basic Findings, Suggestions and Conclusions
REFERENCES


Reserve Bank of India (2001): *RB.I; Reports on Currency and Finance*.


