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THEORETICAL FRAMEWORK OF FOREIGN INVESTMENT

A striking aspect of India’s experience during the last two decades has been a remarkable surge in foreign investment. With the liberalisation of controls on capital inflows as well as the broader impact of reforms on India’s economic prospects, India has attracted substantial foreign investor interest in the post liberalisation period which is reflected in the surging capital inflows.

FDI and FPI as components of capital flows may contribute to fill the savings investment gap and provide the foreign exchange to support growth and development. The contribution of foreign investment to growth can be direct through the financing of investment, which is invariably a source of growth, or indirect through an increase in consumption or absorption, which in turn will induce an increase in investment. The developmental impact is the greatest in the case of direct financing of investment, while the financing of non-productive expenditure can lead to destabilizing effect of overheating or of speculative investment. Foreign investment flows can also bring ancillary services in the form of non-financial benefits to the host economy by enhancing the business environment in which firms operate. In the following section we examine the conceptual and theoretical framework of the study.

2.1 CONCEPTUAL FRAMEWORK OF THE STUDY

The important technical concepts used in the study are explained below.

2.1.1 FOREIGN DIRECT INVESTMENT

The term foreign direct investment (FDI) represents an equity investment which is directly related to the creation of new real capacity. Foreign direct investment is the acquisition of real assets abroad by the residents of a country. Direct investments are real investments in factories, capital goods, land and
inventories where both capital and management are involved and the investor retains control over the use of invested capital. It usually takes the form of a firm starting a subsidiary or taking control of another firm.

2.1.1.1 DEFINITION OF FOREIGN DIRECT INVESTMENT

FDI is the process whereby residents of one country (the home country) acquire ownership of asset for the purpose of controlling the production, distribution and other activities of a firm in another country (the host country).

2.1.1.2 IMF Definition¹

According to the Balance of Payments Manual 5, based on the IMF recommendations, ‘foreign direct investment is the category of international investment that reflects the objective of obtaining a lasting interest by a resident entity in one economy in an enterprise resident in another economy’. The lasting interest implies the existence of a long term relationship between the direct investor and the enterprise and a significant degree of influence by the investor on the management of the enterprise.

2.1.1.3 UNCTAD Definition²

The World Investment Report 2002 published by United Nations Conference on Trade and Development defines FDI as ‘an investment involving a long-term relationship and reflecting a lasting interest and control by a resident entity in one economy (foreign direct investor or parent enterprise) in an enterprise resident in an economy other that that of the FDI enterprise, affiliate enterprise or foreign affiliate’. FDI implies that the investor exerts a significant degree of influence on the management of enterprise resident in the other economy. Such investment involves both the initial transaction between the two entities and all subsequent transactions between them and among foreign affiliates, both

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incorporated or unincorporated. Individuals as well as business entities may undertake FDI.

2.1.1.4 OECD Benchmark Definition

According to Organization for Economic Cooperation and Development (OECD) Benchmark Definition of Foreign Direct Investment (Third Edition), ‘foreign direct investment reflects the objective of obtaining a lasting interest by a resident entity in one economy (direct investor) in an entity resident in an economy other than that of the investor (direct investment enterprise)’. The lasting interest implies the existence of a long-term relationship between the direct investor and the enterprise and a significant degree of influence on the management of the enterprise. Direct investment involves both the initial transaction between the two entities and all subsequent capital transactions between them and among affiliated enterprises, both incorporated and unincorporated.

2.1.1.5 STOCK OF FDI

FDI stock is the value of the share of their capital and reserves (including retained profits) attributable to the parent enterprise, plus the net indebtedness of affiliates to the parent enterprise. Foreign direct investment stocks are the cumulation of the FDI flows. FDI stocks measure the total amounts in existence as of the stated time.

2.1.1.6 FDI FLOWS

Flows of FDI comprise capital provided (either directly or through other related enterprises) by a foreign direct investor to an FDI enterprise, or capital received from an FDI enterprise by a foreign direct investor. FDI has three components, viz., equity capital, reinvested earnings and intra-company loans.

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2.1.1.6.1 EQUITY CAPITAL

Equity capital is the foreign direct investor’s purchase of shares of an enterprise in a country other than its own.

2.1.1.6.2 REINVESTED EARNINGS

Reinvested earnings comprise the direct investors’ 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.

2.1.1.6.3 INTRA-COMPANY LOANS

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.

2.1.1.7 GREENFIELD INVESTMENTS

Greenfield investment refers to investment in new facilities and the establishment of new entities through entry as well as expansion. Greenfield investment is used as a mode of entry in industries in which technological skills and production technology is the key.

2.1.2 FOREIGN PORTFOLIO INVESTMENT

Portfolio investment includes investments by a resident entity in one country in the equity and debt securities of an enterprise resident in another country which seek primarily capital gains and do not necessarily reflect a significant and lasting interest in the enterprise. The category includes investments in bonds, notes, money market instruments and financial derivatives other than those included under direct investment, or in other words, investments which are both below the ten per cent rule and do not involve affiliated enterprises. In addition to securities issued by enterprises, foreigners can also purchase sovereign bonds issued by governments. According to the IMF’s 1996 Coordinated Portfolio
Investment Survey Guide\textsuperscript{4} the essential characteristic of instruments classified as portfolio instruments is that they are traded or tradable.

2.1.2.1 FOREIGN INSTITUTIONAL INVESTORS

Foreign institutional investors are institutions such as overseas pension funds, mutual funds, investment trusts, insurance companies, asset management companies, Sovereign Wealth Funds, institutional portfolio managers, University fund, endowments, foundations or charitable trusts or charitable societies etc registered with SEBI and given approval for investing in financial securities in India.

2.1.2.2 SUB-ACCOUNT

Sub-account means any person resident outside India, on whose behalf investments are proposed to be made in India by a foreign institutional investor and who is registered as a sub-account under the SEBI (FII) Regulations, 1995. sub-account fall into three categories, namely;

- Broad based fund or portfolio which is broad based, incorporated or established outside India.
- Proprietary fund of a registered foreign institutional investor.
- Foreign corporate (which has its securities listed on a stock exchange outside India) having asset base of not less than two billion US dollars and having an average net profit of not less than fifty million US dollars.

2.1.2.3 OVERSEAS CORPORATE BODIES

An Overseas Corporate Body is a company, partnership firm, society and other corporate body owned directly or indirectly to the extent of at least sixty per cent by NRIs and includes overseas trust in which not less that sixty per cent beneficial interest is held by NRIs directly or indirectly but irrevocably.

\textsuperscript{4} Coordinated Portfolio Investment Survey Guide, International Monetary Fund, 1996.
2.1.2.4 GLOBAL DEPOSITORY RECEIPTS (GDRs)

Global Depository Receipt is a dollar denominated instrument traded on a stock exchange in Europe or in USA or both. GDR represents a certain number of underlying shares of the issuing company. The domestic custodian bank instructs an overseas depository bank to issue a negotiable instrument in form of a depository receipt known as GDR. The GDR is issued in any freely convertible currency and can be listed on any international stock exchange. It can be transferred or it can be redeemed. The global depository receipts integrated Indian companies to the global money markets. The foreign investors can invest in Indian companies through the GDR route without any lock-in-period. Reliance Industries Limited made the first GDR issue in May 1992 for an amount of $150 million.

2.1.2.5 AMERICAN DEPOSITORY RECEIPTS (ADRs)

American Depository Receipt is a dollar denominated instrument traded on a stock exchange in USA. ADR represents a certain number of underlying equity shares of the issuing company. American Depository Receipts (ADRs) have become increasingly popular because they offer an easy way for U.S. investor to diversify internationally and allow non-U.S. firms access to raising money in the United States.

2.1.2.6 OFFSHORE FUNDS

Offshore funds are collective investment funds registered in tax havens, typically small islands in the Caribbean, Europe and Asia Pacific. The host countries do not tax these funds and do not forward the financial information to other tax and financial authorities.
2.1.3 INWARD FDI PERFORMANCE INDEX

The Inward FDI Performance Index ranks countries by the FDI they receive relative to their economic size. The index is the ratio of a country’s share in global FDI inflows to its share in global GDP.

The Inward FDI Performance Index is formulated as follows:

\[
\text{IND}_i = \frac{\text{FDI}_i / \text{FDI}_w}{\text{GDP}_i / \text{GDP}_w}
\]

where,

\[
\text{IND}_i = \text{The Inward FDI Performance Index of the } i^{th} \text{ country}
\]

\[
\text{FDI}_i = \text{FDI inflows in the } i^{th} \text{ country}
\]

\[
\text{FDI}_w = \text{World FDI inflows}
\]

\[
\text{GDP}_i = \text{GDP in the } i^{th} \text{ country}
\]

\[
\text{GDP}_w = \text{World GDP}
\]

2.1.4 INWARD POTENTIAL INDEX

The Inward FDI Potential Index is the average of the scores on twelve economic and policy variables for each country. The twelve variables are GDP per capita, real GDP growth over the previous ten years, exports as a percentage of GDP, number of telephone lines per 1000 inhabitants, commercial energy use per capita, R&D expenditures as a percentage of gross national income, students in tertiary education as a percentage of total population, country risk, the world market share in exports of natural resources, the world market share of imports of parts and components for automobiles and electronic products, the world market share of exports of services and the share of world FDI inward stock.

\[
\text{Score} = \frac{\text{Vi} - \text{V min}}{\text{V max} - \text{V min}}
\]

where,

\[
\text{Vi} = \text{the value of a variable for the country i.}
\]

\[
\text{V min} = \text{the lowest value of the variable among the countries.}
\]

\[
\text{V max} = \text{the highest value of the variable among the countries.}
\]
2.1.5 NEER AND REER

The NEER is the weighted geometric average of the bilateral nominal exchange rates of the home currency in terms of foreign currencies. Specifically,

\[
\text{NEER} = \prod_{i=1}^{n} (e/e_i) w_i
\]

The REER is the weighted average of NEER adjusted by the ratio of domestic price to foreign prices. Specifically,

\[
\text{REER} = \prod_{i=1}^{n} [(e / e_i) (P / P_i)] w_i
\]

where

- \(e\) : exchange rate of Indian rupee against a numeraire in indexed form.
- \(e_i\) : exchange rate of foreign currency ‘i’ against the numeraire in indexed form.
- \(w_i\) : weights attached to foreign currency/country ‘i’ in the index

\[
\sum_{i=1}^{n} w_i = 1
\]

- \(P\): India’s wholesale price index (WPI),
- \(P_i\): Consumer Price Index of Country ‘i’, and
- \(n\): Number of countries/currencies in the index other than India.

2.2. NATURE OF FOREIGN INVESTMENTS

We present the nature of foreign investment—both direct and portfolio in the following section.

2.2.1 FOREIGN DIRECT INVESTMENT

During the nineties, foreign direct investment (FDI) accounted for an increasing share of private capital flows to developing countries. With the opening up of the Indian economy in the early nineties, FDI inflows have shown a consistent growth, bringing in more than US $ 35 billion in 2008-09 as compared with US $ 129 million in 1991-92. The survey of World Investment Report 2008
found that India ranks 106th position in terms of inward FDI Performance Index, which is the ratio of a country’s share in global FDI flows to its share in global GDP.

One distinguishing feature of FDI from the viewpoint of direct investors is that direct investment enterprise often represents units in a multinational corporation, the overall profitability of which depends on the advantage to be gained by deploying the various resources available to the investors in units located in different economies.

The Government of India shows a more open attitude towards FDI because of its features. Firstly, FDI is viewed a means through which the country secures large inflows of essentially non-debt creating financial flows. Secondly, FDI is also seen as a conduit for promoting exports of manufactures from the host economy.

The flow of FDI needs large internal markets and import substituting strategies. The countries that have followed a more open development strategy have had fewer problems with direct investment. FDI is motivated largely by the investor’s long-term prospects for making profits in production activities that they directly control. As FDI is non-debt creating asset, it is considered as the most desirable way of getting the external inflows.

Multinational corporations engaged in manufacturing, resource extraction or services usually undertake direct investments. Direct investments are now the principal channel of international private capital flows. Direct foreign investment provides non-debt creating funds which are considered as a source of external finance.

FDI usually flows as a bundle of resources including capital, production technology, organizational and managerial skill, marketing know-how and market access through the marketing network of multinational enterprises (MNEs). The
bulk of FDI flows continue to be market seeking type and actually substitute trade. FDI occurs when a firm invests directly in facilities to produce and/or market a product in a foreign country. FDI takes on two main forms: the first is a green-field investment, which involves the establishment of a wholly new operation in a foreign country. The second involves acquiring or merging with an existing firm in the foreign country.

The contribution of FDI to development is direct. Multinational corporations establish subsidiaries and affiliates which directly increase the level of investment in host countries and augment their productive capacity and employment. Hence, capital formation can take place. FDI can also bring ancillary services in the form of transfer of technology, management expertise and marketing skills, although this is not always the case. FDI can broaden the access to export markets as multinational corporations often serve as channels for the distribution of goods from one country to other markets. Multinational corporations also assume fully the risks that their affiliates might encounter in their activities in host economies. In principle earnings are repatriated if the affiliates are profitable, thus investment will be repaid by profits.

2.2.2 PORTFOLIO INVESTMENT

Portfolio flows are basically transient in nature. At anytime they can be withdrawn for totally extraneous reasons. This could lead to a negative interaction between two inherently unstable markets, the currency and the stock markets, which could do enormous damage to the real economy. An increase in portfolio investment by foreign institutional investors may have an impact on equity price movement.

Portfolio investment is far more flexible; nevertheless it offers the investor long term returns and diversified risk without the responsibility of management and control. A rise in capital inflows, particularly portfolio inflows by foreign institutional investors in countries with flexible exchange rate system could lead to
excessive volatility in nominal exchange rate and where price stability is an objective that the excessive inflows of capital has serious monetization effect.

2.3 SIGNIFICANCE OF FOREIGN INVESTMENTS

We now analyse the nature of foreign investment—both direct and portfolio in the following section.

2.3.1 FOREIGN DIRECT INVESTMENT

Foreign direct investment is perceived as a means of enhancing trade, productivity and economic restructuring in a nation thereby leading to competitive advantage for any nation. FDI typically helps in strengthening local assets, resources and capabilities.

The two-gap model has been used to focus on the specific role of foreign investment in relieving the foreign exchange requirements of growth. The “two-gaps” refers to the gap between savings and investments and the gap between foreign exchange availability and import needs. Domestic savings may not be translatable into foreign exchange earning necessary to acquire imports and FDI can ease the foreign exchange bottleneck in such a situation as well as bring additional savings and bridge the gaps.

In recent years, FDI acts as a provider of technology and even more recently as a supplier of managerial skills and marketing channels in addition to the traditional roles of supplementing domestic savings and relaxing the foreign exchange constraints.

The rationale for the more transparent policy on FDI can be traced to at least three reasons: i) FDI would bring attendant advantages of technology transfer, marketing expertise and introduction of modern managerial techniques. ii) FDI would bring in new possibilities for promotion of exports and iii) FDI would attract substantial investment.
The significance of FDI in a fast developing country like India lies in bridging the saving-investment gap so as to achieve sustained growth of the economy. In the context global economic integration, FDI can play a key role in improving the capacity of the host country to respond to the emerging opportunities. For a developing country, FDI is significant for employment generation and improving its productivity. Hence the international flow of capital is considered as an alternative to labour migration from the poor countries. FDI brings to the recipient country not only foreign capital but also efficient management, superior technology and innovations in products and marketing technique.

The increased inflow of foreign funds into the developing countries like India is expected to act as catalyst of economic growth. FDI may lead to capital formation by supplementing resources. Thus foreign investment in general and direct investment in particular enhances the size of the total investment.

On the negative side, FDI entails a loss of control on domestic production, and even possibly on domestic development options. As FDI is firm- and sector-specific, the development of particular sectors of production will be left to foreigners' choice and not to deliberate domestic options. Furthermore, FDI can crowd out domestic enterprises through unfair competition and through raising important sums of local savings. FDI can also have a negative impact on the balance of payments if production by affiliates requires important volumes of imports, the more so if production is geared towards host country's domestic markets and not towards export markets. FDI can be costly in the long run, as repatriated earnings and royalties tend to increase with the maturity of affiliates.

2.3.2 FOREIGN PORTFOLIO INVESTMENT

Foreign portfolio investment is expected to reduce the cost of capital and helps the development of domestic capital market, thus enhancing the size of the total investment. At the same time, high levels of portfolio investment may lead to
inflationary trend as it may expand money supply into the domestic market. There is, thus a need to safeguard against excessive outflows as a result of investment in the form of repatriation of profits and dividends etc through a policy of incentives for reinvestments especially in the infrastructure projects.

As there are many forms of FPI, the contribution to development can be direct as well as indirect. FPI is a fungible form of finance, i.e. it is not firm or sector-specific. It can be used by domestic enterprises and foreign-owned enterprises. Sometimes, by increasing the amount of finance available for domestic enterprises, it can enhance their competitiveness.

Some forms of FPI, such as venture capital, primary equity issues (on the domestic or international capital markets) and corporate bonds can make a valuable direct contribution to the financing of investment. Other forms of FPI such as purchases by foreigners of securities on domestic secondary markets, most of government bonds and derivatives have rather an impact on domestic wealth and absorption. This will increase consumption through two channels. First, the positive wealth effect generated by the increase in asset prices could encourage an increase in consumption by wealth holders, unless they decide to invest in other securities or assets. Secondly, portfolio asset purchases from residents increase bank liquidity and encourage a credit boom. The increase in domestic absorption is not a bad thing in itself, if this also leads to an increase in investment through the accelerator effect. However, if credit boom increases opportunities of financing speculative activities or has a high inflationary pressure, the economy will suffer a setback.

FPI can also bring ancillary benefits through addition to the liquidity of domestic capital markets, thus favouring its development. It can also encourage the development of other financial intermediaries, thus strengthening the financial infrastructure and deepening the process of financial intermediation. FPI can also lead to more corporate governance, as more transparency and disclosure will be
required from companies by foreign investors. Such developments on domestic capital markets can increase the amount of risk capital available for new enterprises.

On the negative side, the costs of finance can be higher than the benefits derived there from. If equity investment involves some degree of risk sharing, it is not the case for bonds, which require the payment of coupons, unrelated to the profitability of enterprises which issued these bonds. But the biggest negative impact is the high volatility risk of FPI.

2.3.4 FDI Versus FPI

FDI and FPI have different characteristics. FDI and FPI address different financing needs: the first one is foreign-owned, while the latter one is more used by domestic companies/entities. FDI is firm and sector-specific, while FPI is more fungible. FPI has a greater macroeconomic impact (through changes in asset prices and liquidity in the financial sector), while FDI can have a significant impact at the microeconomic level, shaping the productive structure of a host country. Unlike FDI, portfolio investors do not have managerial responsibilities in their investment and very often do not have a physical presence in host countries. The decision by TNCs to undertake FDI in one particular country is influenced mainly by this country's determinants, while FPI can be affected by factors external to host economies, such as financial policies in capital exporting countries, the state of liquidity on international capital markets, and changes in the pattern of diversification of international portfolio. And finally, FPI has a shorter investment horizon and is more liquid and more volatile than FDI.

FDI is in general less volatile than FPI. FDI is made in recipient countries through the establishment of production lines which would be difficult to dissolve in a short time. Therefore, disinvestment or reversibility is much more difficult to undertake than in the case of portfolio investment, which can be easily sold off on financial markets.
Volatility of capital flows can create an unstable investment environment detrimental to growth and development. There are many channels through which volatility exert a negative impact on the economy. The first is through unexpected changes in the availability of finance, and consequential changes in its cost and in asset prices. This will induce high variability in expected profits, making difficult investment planning. The second is through the effects of compensatory adjustment in monetary, fiscal and exchange rate policies in the face of rapid changes in the availability of external finance. And finally, capital volatility has an impact on consumption, and consequently on growth.

FDI is viewed as “good cholesterol” because it can confer the following benefits to the host countries according to Hausmann and Fernandez\(^5\).

1. FDI allows the transfer of technology—particularly in the form of new varieties of capital inputs—that cannot be achieved through financial investments or trade in goods and services. FDI can also promote competition in the domestic input market.

2. Recipients of FDI often gain employee training in the course of operating the new businesses, which contributes to human capital development in the host country.

3. Profits generated by FDI contribute to corporate tax revenues in the host country.

In contrast, FPI is viewed as “bad cholesterol” because it is driven by speculative considerations based on interest rate differentials and exchange rate expectations, not on long-term considerations. Its movement is often the result of moral hazard distortions such as implicit exchange rate guarantees or the

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willingness of governments to bailout the banking system. It is the first to run for the exits in times of trouble.

Foreign direct investment has proven to be resilient during financial crises. For instance, FDI in East Asian countries was remarkably stable during the global financial crises of 1997-98. In sharp contrast, portfolio flows were subject to large reversals during the same period. The resilience of FDI during financial crises was also evident during the Mexican crisis of 1994-95 and the Latin American debt crisis of the 1980s. As a result, FDI inflows into developing countries are often viewed as stable cold money, which are generated by long term risk-return considerations. In contrast, foreign portfolio flows are often deemed as unstable hot money, which are triggered by short term considerations.\(^6\)

**2.4 DETERMINANTS OF FOREIGN INVESTMENTS**

The most important determinants of foreign investments from a theoretical perspective are presented in the following section.

**2.4.1 DETERMINANTS OF FOREIGN DIRECT INVESTMENT**

In order to understand why FDI flows to some countries instead of others, the host country characteristics need to be examined. Wang and Swain\(^7\) classified host country characteristics into micro and macro determinants of FDI.

**2.4.1.1 MICRO DETERMINANTS OF FOREIGN DIRECT INVESTMENT**

The micro determinants of FDI are mainly concerned with those location-specific factors that have an impact on the profitability of FDI at firm or industry level. Host country characteristics that influence productivity and cost at the micro level include market size and growth, labour costs, host government policies and tariffs and trade barriers.


2.4.1.1.1 Market Size and Growth

FDI is likely to be attracted to host countries with large local markets and higher levels of economic growth. A large, growing domestic economy ensures the transnational corporations of a market for its product and provides for scale economies. Evidence from empirical studies provides strong support for the importance of market size as a determinant of FDI. A number of early studies surveyed by Wang and Swain from the 1960s and 1970s conclude that most studies come out in support of the size or growth of the markets in the host countries as a significant determinant of FDI. In more recent work, Schneider and Frey\(^8\) and Wheeler and Mody\(^9\) also find market size to be related to FDI flows.

2.4.1.1.2 Labour Costs

Labour costs are a clear consideration in the decision of a transnational corporation to employ its ownership advantages outside its home country. As wages rise, FDI aimed at low cost, efficient production, tends to be discouraged. Though as wages rise relative to the cost of capital, there may be a tendency to substitute foreign capital in the place of labour. Firms may also not only be interested in the lowest of wages. Transnational corporations may seek skilled labourers and professionals. Rather than just low wages, it is important that wages reflect productivity. A related factor to take into account is that of labour disputes. A given host country is less attractive if greater is the incidence or severity of industrial disputes.

The results of time series and cross-country analyses are also strongly in favour of relative low wages as a significant determinant of FDI flows. Specifically in the case of developing countries, Wheeler and Mody (1992) and

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Lucas\textsuperscript{10} find a positive and significant relationship between lower labour costs and FDI inflows.

2.4.1.1.3 Host Government Policies

Host government policies are location specific factors that may influence profitability and transnational corporations’ decision to undertake FDI in a number of ways. Such policies include incentives and performance requirements. Host governments often offer incentives to increase the attractiveness of their location. The incentives aim to encourage FDI inflows by reducing costs and making investment more profitable. Specific measures include tax breaks and trade incentives, like duty-free imports of inputs. The incentive schemes are often closely linked to efforts by the host government to encourage investment in export industries, or preferred sectors, or in less developed areas of the country. Most host countries believe that incentive schemes are crucial for attracting FDI, because competing economies have similar schemes.

Performance requirements are placed on the investors by the host government to ensure that the benefits of FDI accrue to the country. This takes the form of requirements concerning the hiring and training of local personnel, local content, technology transfer and exporting of output. Incentive schemes generally attract FDI, whereas the performance requirements by the government may deter it.

2.4.1.1.4 Tariff and Trade Barriers

According to the ‘tariff hopping’ hypothesis, high protective trade barriers make exports by transnational corporations to a potential host country uncompetitive. Potential marketing cost savings as well as transport cost reductions encourage transnational corporations to enter the market through FDI and to serve their customers with local facilities. A growing internal market will

add to the attractiveness of tariff hopping. Jun and Singh\textsuperscript{11} tests the tariff hopping hypothesis and finds the relationship between taxes on international trade and transactions, and FDI to be positive and significant.

\textbf{2.4.1.2 MACRO DETERMINANTS OF FOREIGN DIRECT INVESTMENT}

The macro determinants of FDI are the factors that influence profitability and the choice to invest at an economy-wide level. These include openness and export orientation, exchange rates, the inflation rate, budget deficit, domestic investment and political risk.

\textbf{2.4.1.2.1. Openness and Export Orientation}

There are differing views regarding the relationship between openness and FDI flows. According to the ‘tariff-hopping’ hypothesis closed economies receive FDI, which is trade-substituting. The opposing view is that outward-oriented economies are more successful in attracting FDI. The open economies, subject to international competition, are forced to attain higher productivity. An outward oriented economy is also not handicapped by the size of its domestic economy when attracting FDI-it offers access to world markets. Lucas finds that in Southeast Asian countries FDI is more elastic with respect to the demand for exports, than with respect to the aggregate domestic demand.

\textbf{2.4.1.2.2. Exchange Rates}

There are two approaches concerned with the significance of exchange rates as a determinant of FDI: the currency area hypothesis and considerations of exchange rate risk. The currency area hypothesis argues that firms from harder currency areas are able to borrow at lower costs, and to capitalize their earnings on their FDI in softer currency areas at higher rates, than the local firms. The higher the share of capital value added and the size of the premium on the local currency,

the greater the comparative advantage which foreign investors enjoy over local firms that attracts FDI.

The second approach takes account of the exchange rate risk to which transnational corporations are exposed when undertaking FDI and how that influences the decision to locate in a particular country. The nature of the risk depends on the transnational corporations’ activities in the host country. If the transnational corporations produce for export, depreciation is beneficial, making output more competitively priced. However, if a substantial portion of inputs is imported, depreciation raises costs.

Large fluctuations in the exchange rate discourage FDI flows, as it increases uncertainty associated with the economic environment of the host country. The exchange rate also determines the value of repatriated profits. In developing countries a deteriorating exchange rate and foreign exchange reserve position may further threaten restrictions on such remittances.

2.4.1.2.3. Inflation Rates

Inflation rate is an indicator of a country’s internal macroeconomic stability. A high rate of inflation is a sign of internal economic tension and the inability or the unwillingness of the government and the central bank to balance the budget and to restrict money supply. This increases uncertainty regarding the business environment. Increased instability adds to uncertainty and makes investment unattractive. Inflation also increases the cost of production. Consequently it has a negative impact on FDI flows.

2.4.1.2.4. Budget Deficits

A high or increasing budget deficit of the host country discourages FDI flows. It is likely to cause uncertainty regarding the sustainability of the host government’s fiscal stance having implications for the cost and profitability of
investment. Empirical work by Chaudhuri and Srivastava\textsuperscript{12} supports a negative relationship between budget deficits and FDI flows.

2.4.1.2.5. Domestic Investment

FDI supplements domestic capital but the causation also runs the other way: domestic investment crowds in FDI. It does so by increasing productive capacity. In the same way infrastructure creates an enabling environment for foreign investors. It increases productivity and reduces the cost of production, which draws in FDI. This relationship is confirmed by a number of empirical studies.

2.4.1.2.6. Political Instability

Political instability embodies a variety of concerns, ranging from production disruption to confiscation or damage to property, to threats to personnel, to a change in macroeconomic management or the regulatory environment. Political instability is expected to decrease FDI because it increases uncertainty about the cost and profitability of investment. Political stability, on the other hand, may not have the positive effects on FDI.

2.4.2 DETERMINANTS OF FOREIGN PORTFOLIO INVESTMENT

The determinants driving portfolio investors are more complex, involving the interactions of factors related to external environment, investors' strategies and specific host country determinants.

As many developing countries and countries in transition have embarked on a process of market liberalization and structural reform, the number of markets to which international investors were able to allocate their savings has grown substantially over the last twenty years. In parallel, the tremendous growth of investible assets managed by institutional investors (pension funds and mutual

funds) in OECD countries has flooded international capital markets with liquidity. Accompanied by rapid financial innovation, the combination of these events produced changes in investor strategies as well as a re-allocation of funds towards emerging markets.

There are two key factors which explain the increased interest of international investors towards emerging markets as a group: potentially higher returns and the benefits of diversification. Once the decision is taken to invest in emerging markets, the allocation of funds to specific markets will depend on host country determinants. Some host country determinants are of critical importance for fixed income investors and are of minor importance to equity investors and vice-versa.

Determinants of FPI can be put into two groups: economic determinants and policy/regulatory determinants. Economic determinants are not directly linked to policies aimed at attracting foreign portfolio flows. Instead, they are a reflection of the general health of the economy, the potential for firms operating in such a business environment to earn profits, and to obtain a satisfactory return on fixed income investment. Investors will typically focus on the following factors:\footnote{Comprehensive Study of the Interrelationship between FDI and FPI, Staff Paper. UNCTAD. June 1999.}

- high economic growth rate
- exchange rate stability
- macroeconomic stability
- level of foreign exchange reserves
- health of domestic banking system
- stock and bond market liquidity
- real interest rates.
Some of the above factors will be of more importance to equity investors and others to fixed income investors. For example, high economic growth rates and the liquidity of the stock market will be of particular importance to portfolio managers specializing in equity investments. On the other hand, the degree of bond market liquidity and the level of real interest rates will be of particular importance for fixed income investors.

The other set of determinants to which foreign investors pay particular attention includes policy and regulatory frameworks in individual emerging markets. These are the factors over which domestic governments have a direct influence. The main determinants in this group are the following:

- ease of repatriating dividends and capital
- domestic capital gains tax
- stock and bond market regulation
- quality of domestic accounting and disclosure standards
- speed and reliability of the settlement system
- availability of domestic custodians and brokers
- degree of investor rights protection.

It is not possible to isolate any single factor as being the most important, although some tend to carry more weight than others. For example, the degree of investor rights protection and the ease of repatriating dividends and capital are often cited as being closely watched by potential investors.

2.5 THEORIES OF FOREIGN INVESTMENT: AN OVERVIEW

An overview of theories relating to foreign investment is presented in this section. Theories of foreign investment are broadly classified into three groups: (1) theories based on the growth of the firm; (2) macroeconomic approaches and
other theories. Theories of the firm which explain foreign investment as a result of the growth of the firms are discussed first.

2.5.1. THEORIES OF FIRMS ON DIRECT FOREIGN INVESTMENTS

The important theories of foreign direct investment based on the growth of the firm are business administration approach, industrial organization approach, product cycle approach and catching up product cycle approach.

2.5.1.1 Business Administration Approach

The first and the most influential theory of foreign direct investment, which concentrates on the growth of the firm, is known as the business administration approach.¹ It views the activities of direct foreign investment as a natural consequence of the growth of a firm. The theory analyses the process in which a US firm begins overseas activity to become a multinational firm. The decision making of the firm changes from the traditional domestic market to a world market orientation. The organization of the firm goes through a number of changes, first with the strengthening of its export section, then to the independence of the international business section, next to the establishment of a foreign subsidiary and finally to the central control of subsidiaries all over the globe. Consequently, the firm faces new problems such as negotiation with foreign governments, the handling of foreign currencies and other assets, dealings with foreign labourers, arbitration of international conflicts, and so forth. These problems were never encountered in the domestic market.

The business administration approach seeks to give guidelines to the firm concerning the type of management which would best confront the above mentioned problems. It is more a source of advice to the management of multinational corporations than an explanation of foreign investment. The approach is, therefore, confined theoretically to the analysis of one commodity produced by one firm, even though firms produce many products in practice.
2.5.1.2 Industrial Organization Approach

Theories coming under the industrial organization approach suggest that firms venture into direct foreign investments because of their oligopolistic characteristics and that their investment and operation abroad enable them to survive by strengthening and expanding oligopolistic systems. These theories explained the US-type direct foreign investment as a natural consequence of the growth and expansion of oligopolistic firms.

In Stephen Hymer’s view, direct foreign investment is typical of an oligopolistic firm, which has some sort of superiority, searching for control in an imperfect market in order to maximize profits. He observed that indigenous firms have advantages over foreign enterprises in the domestic market, because of their better knowledge of the local environment. In order to compete with local firms, foreign enterprises must therefore have some advantages that compensate for the disadvantage of operating in a foreign environment. According to Richard E Caves, newest products tend to be oligopolistic in their nature because of product differentiation and the development, refinement and sale of underground resources such as oil are suited to vertical integration, which strengthens the oligopoly.

2.5.1.3 Product Cycle Approach

Another approach related to the oligopoly theories is Raymond Vernon’s product cycle theory. Its special feature lies in the combination of a three stage theory of innovation (new-phase stage), growth, and maturing of a new product. In the new-phase stage, the design of the product is often changed. Hence its production is technologically unstable and the market is not yet familiar with the product. Its sales will not grow rapidly and demand for the product will remain price-inelastic. At this stage research and development activities of scientists and technicians have decisive importance for the introduction of inventions and the changes in design thereafter.
At the growth stage, after the new phase stage, sales of the product increase. Mass production and bulk sales methods are introduced. At the same time, entries in the industry increase and competition intensifies among producers. Demand becomes price elastic so the sales of each firm become more responsive to price.

Finally, when the mature stage is reached, the product becomes standardized and its production technologically stable. The use of skilled and unskilled labour becomes all the more important at this stage. Accordingly through foreign investment the production location moves to low wage developing countries. The costs of marketing exports of the product from these countries may be low compared with other commodities, since the commodity is standardized.

According to Vernon, new products created in the United States first enjoy a monopolistic position. Exports increase when mass production is introduced and the cost reduced. But threats to this export position arise and exports decrease. The threats include tariffs in the importing countries, import quotas, domestic production in importing countries and entrance of other multinationals into the import market. Thus direct foreign investment is a monopolistic defence of the market and could be made before the mature stage.

2.5.1.4 Catching-up Product Cycle Approach

The catching-up product cycle approach is associated with Kaname Akamatsu. He used the model to explain the industrial development of Japan. Initially a new product is invented and manufactured on a large scale in leading industrial countries. In a developing or catching-up country, the product cycle starts with imports of the new product with superior quality. A learning process follows and is assisted by importing technological know-how and by direct foreign investment. The expansion of production then leads to the exploitation of economies of scale, increases in productivity, improvements in quality and reductions in costs. This involves an import substitution process. But as domestic
costs reach the international competitive cost level, foreign markets are developed, the scale of production is extended further and costs are reduced again. Thus the expansion of exports that is originally made possible by the growth of domestic demand in its turn provides a stimulus to industrial development. Such successive development of imports, domestic production and exports is called the catching-up product cycle. Such a product cycle takes place only for standardized, rather than new products, in developing countries.

2.5.2 MACROECONOMIC APPROACHES

Important theories coming under the macroeconomic approaches are the MacDougall-Kemp model, the theory of optimal taxation and the Uzawa-Hamada thesis.

2.5.2.1 The MacDougall-Kemp Model

A macroeconomic analysis of the effects of international capital movement or foreign investment was initiated by G.D.A. MacDougall and subsequently elaborated by Murray C Kemp. The crux of the theory is that when capital moves freely between the countries of the world, marginal productivities of capital are equalized internationally. As a result of liberalization of international capital movements, the efficiency in the use of world resources improves which leads to an increase in the output of the world and the gain is shared by both the investing and host countries which augment the welfare of both nations.

The analysis of MacDougall and Kemp has important influences on later development in the theory of direct foreign investment. Special attention has been paid to the problem of taxation of the returns to foreign investment and a theory of optimum taxation of foreign investment has been developed.

2.5.2.2 The Theory of Optimal Taxation

The theory of optimal taxation, developed by Koichi Hamada, concentrates on the taxing systems which allocate a larger amount of the gains from investment
to the country which initiates the tax. Rather than permit investment to the point where total joint gains of the investing and host countries are maximized, a country can restrict investment and thus be better off. The host country can impose a tax on the profits of foreign owned capital. The investing country can tax the returns from foreign investment after the tax in the host country is deducted. The investing country can impose a tax on the returns to domestic investment as well. Investors in that country decide whether they should invest domestically or abroad by comparing the after-tax returns from domestic and foreign investments, and when the latter is higher, they invest abroad until the returns are equalized.

2.5.2.3 The Uzawa-Hamada Thesis

The theory was originally propounded by H. Uzawa and later elaborated by K. Hamada. The Uzawa-Hamada thesis states that when an import to the host nation is hindered by the levy of tariffs, the investing country will undertake direct investment in the host nation, by setting up a factory in the host economy behind its tariff wall. According to them in such a situation the host country will suffer a loss in national income and welfare. Welfare is lower when host country producers, domestic or foreign-owned, are protected by the tariff. Foreign capital inflows can share the benefits of protection with domestic capital. It is this larger regard to the foreign capital which results in the decrease in domestic welfare. Thus under a system of protective tariffs, entry of foreign capital into the protected industry reduces welfare in the host country, and thus the country should not invite foreign capital. If the country wishes to invite foreign capita into the country, the country should first eliminate tariffs in the industries involved.

2.5.3 OTHER THEORIES

Internalization theory and the eclectic theory are the other theories explaining foreign investment.
2.5.3.1 Internalization Theory

The internalization theory of foreign investment was originally propounded by McManus. He emphasized the role of transaction costs in the development of foreign operations. His analysis recognizes the existence of important interdependences between activities conducted in different countries and the need to coordinate the activities of the interdependent parties. There are three ways in which to coordinate economic agents: (1) decentralized decision making leading to transactions at arm’s length, making use of the price mechanism; (2) contractual agreements and (3) the internalization of transactions within a single institution, through the establishment of an international firm. However, the price mechanism cannot be used without cost. There are transaction costs arising from the need to specify the attributes of the good to be exchanged, or from the difficulties in quantifying the flows of services or assets being exchanged. When the transacted commodity is information, transaction costs can be expected to be high or perhaps even prohibitive. The multinational corporation then arises as a response to market failures, as a way to increase allocative efficiency in the presence of high costs of coordinating economic activity between independent economic agents.

The internalization theory was further developed by Buckley and Casson. According to them, different business activities are linked by flows of intermediate products, embracing not only ordinary semi-processed materials, but also knowledge and information in the form of technological expertise and skills embodied in goods and human capital. The theory further postulates that external markets are often inefficient, particularly with regard to transactions in intermediate products that embody firm-specific intangible assets. This is because specification and pricing of these products is particularly difficult. Moreover, external markets in knowledge-intensive products are difficult to organize and usually do not cover the multiple eventualities given rise to by transactions in information. Thus, when appropriate external markets do not exist, or when the
costs of operating in them are higher than the benefits, there are incentives for the multinational corporation to develop its own internal organization structure to achieve internal coordination of activities.

Hence the internalization theory sees the multinational corporation as the outcome of a process in which firms attempt to secure rents from their intangible assets in the presence of market imperfections. The emphasis is no longer on the possession of firm-specific advantages leading to market imperfections; but rather on the nature of markets, their weaknesses and limitations, and the organization of firms as a response to market imperfections.

2.5.3.2 Eclectic Theory

The theory of foreign investment developed by J.H. Dunning is often referred to as the OLI paradigm. Arguing that no single theory could explain the existence of foreign direct investment, he proposed an eclectic approach in order to reconcile the different approaches and hypotheses. According to Dunning, international production is the outcome of a process in which ownership, localization advantages and internalization work together. The ownership advantages are firm-specific in the sense that the firm has control over them. They embrace patents, expertise, labour skills and other forms of superior production technology, control over markets and trade monopolies, scale advantages, managerial capabilities and so on. These factors determine a firm’s competitive position in relation to other firms. The internalization advantages arise from the existence of market imperfections like the undesirability of providing full information to a prospective purchaser, uncertainty, economies of scale and problems of control. They explain the firm’s reluctance to engage in licensing agreements. Location advantages are those associated with the availability of inputs for all firms established in certain country. They comprise natural resources, location, cultural and political environment, factor prices and transport costs, but also government policies such as trade barriers (quotas, tariffs) and local
content requirements. These circumstances explain why a firm could undertake production abroad instead of producing for export from the home country.

An overview of the theories of foreign investment reveals that not only the business administration approach and growth of the firm approach but also the macroeconomic approach are basically one-commodity analyses and hence, partial equilibrium analysis. Consequently, they cannot be said to be true macroeconomic theories. All are based also on the principle of absolute competition for profit maximization by capital.

The remaining theories on direct investment summarized above focus on the determinants of foreign direct investment. Other aspects related to the behaviour of multinational corporations have received less attention, at least as far as empirical work is concerned. Yet it is obvious that multinational corporations will differ in their behaviour, depending on the characteristics of their technologies and products and the characteristics and policies of their host countries.

2.6 THEORETICAL FRAMEWORK OF THE STUDY

A striking aspect of India’s experience during the last two decades has been a remarkable surge in foreign investment-both direct and portfolio. The main objectives of our study are to examine the structural change in foreign investment and its impact on macroeconomic variables like current account deficit, exchange rate, money supply, foreign exchange reserves and the sources of external financing.

Theoretically speaking, the major reason for the opening up of the Indian economy was to meet the increasing balance of payments deficit and to reduce the mounting pressure on India’s external debt. Since foreign investment inflows are non-debt creating in nature, increased inflows will help stabilize the external debt of a country. Besides, there will be paradigm shift in the sources of external
finance, that is, from the conventional debt creating flows like external commercial borrowings and external assistance.

The current account deficit can be met safely by a nation provided the nation has adequate foreign exchange reserves. Increased foreign investment inflows will accelerate the cumulation in the stock of foreign exchange reserves which if raised to a safe level will provide a cushion to the economy which is likely to face unforeseen external shocks in the era of globalization. Determination of the exchange rate, if left to the discipline of the market, will move in tandem with increased inflows or a slowdown in the inflows or when there is a net outflow. Theoretically, increased foreign investment inflows will exert a mounting pressure on the home currency and the likely result is that it will appreciate. If the home currency is not appreciating in the event of massive inflows, it is an indication of the fact that the exchange rate is being protected by the central bank for the fear that any nominal appreciation of the rupee could have eroded India’s export competitiveness. Another factor which is likely to prevent a currency appreciation in this context is a rise the current account deficit which will absorb part of the increased supply of dollars on the foreign exchange market.

Faced with huge capital inflows, if the government is concerned about maintaining the stability of its exchange rate and intervenes by buying foreign exchange, domestic liquidity increases unless the domestic liquidity consequences are offset through sterilization. Sterilized intervention by the central bank is necessary because an expansion in the money supply is deemed undesirable due to the inflation concerns.

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1 The leading advocates of this approach are John Fayerweather, Richard D Robinson, William A. Dymza, Edith Penrose, S.M.Robbins and R.B. Stobaugh.