CHAPTER I
INTRODUCTION

1.1 OVERVIEW

India is a latecomer to economic reforms, embarking on the process in earnest only in 1991, in the wake of an exceptionally severe balance of payments crisis. There is a need for a policy shift in South Asian countries, as many countries in East Asia achieved high growth and poverty reduction through policies which emphasized greater export orientation and encouragement of the private sector. (Ahluwalia Montek S, 2002).

The purpose of this research is to explore the impact of foreign direct investment (FDI) inflows on growth in Indian economy. The research begins by considering how foreign direct investment (FDI) affects overall growth. Following this, the effect on growth in different sectors is also examined. The basic goal of this study is to determine the policy options that are suitable for promoting development and growth in India.

India took some steps in this direction in the 1980s, but it was not until 1991 that the government signaled a systemic shift to a more open economy with greater reliance upon market forces, a larger role for the private sector including foreign investment, and a restructuring of the role of government (Ahluwalia Montek S, 2002).

India’s economic performance in the post-reforms period has many positive features. The average growth rate in the initial ten year period from 1992-93 to 2001-02 was around 6 percent and it is around 8 percent in the recent ten year period from 2002-2003 to 2011-2012. (Economic survey 2001-2002), which puts India among the fastest growing developing countries in the 1990s.

World economic growth was slower in the second half of the 1990s and that would have had some dampening effect, but India’s dependence on the world economy is not
large enough for this to account for the slowdown. Critics of liberalization have blamed the slowdown on the effect of trade policy reforms on domestic industry (Nambiar et al., 1999; Chaudhuri, 2002). However, the opposite view is that the slowdown is due not to the effects of reforms, but rather to the failure to implement the reforms effectively. This in turn is often attributed to India’s gradualist approach to reform, which has meant a frustratingly slow pace of implementation. However, even a gradualist pace should be able to achieve significant policy changes over ten years. The average growth in the recent ten year period from 2002 - 2012 is around 9 percent (Economic survey 2011 - 2012).

Liberalizing foreign direct investment was an important part of India’s reforms, driven by the belief that this would increase the total volume of investment in the economy, improve production technology, and increase access to world markets. The policy now allows 100 percent foreign ownership in a large number of industries and majority ownership in all except banks, insurance companies, telecommunications and airlines. Procedures for obtaining permission were greatly simplified by listing industries that are eligible for automatic approval up to specified levels of foreign equity (100 percent, 74 percent and 51 percent). Potential foreign investors investing within these limits only need to register with the Reserve Bank of India. For investments in other industries, or for a higher share of equity that is automatically permitted in listed industries, applications are considered by a Foreign Investment Promotion Board that has established a track record of speedy decisions. In 1993, foreign institutional investors were allowed to purchase shares of listed Indian companies in the stock market, opening a window for portfolio investment in existing companies.

These reforms have created a very different competitive environment for India’s industry than existed in 1991, which has led to significant changes. Indian companies have upgraded their technology and expanded to more efficient scales of production. They have also restructured through mergers and acquisitions and refocused their activities to concentrate on areas of competence. New dynamic firms have displaced
older and less dynamic ones: of the top 100 companies ranked by market capitalization in 1991, about half are no longer in this group. Foreign investment inflows increased from virtually nothing in 1991 to about 0.5 percent of GDP. Although this figure remains much below the levels of foreign direct investment in many emerging market countries (not to mention 4 percent of GDP in China), the change from the pre-reform situation is impressive. The presence of foreign-owned firms and their products in the domestic market is evident and has added greatly to the pressure to improve quality.

These policy changes were expected to generate faster industrial growth and greater penetration of world markets in industrial products, but performance in this respect has been disappointing. Unlike the case in China and Southeast Asia, foreign direct investment in India did not play an important role in export penetration and was instead oriented mainly towards the domestic market.

India’s liberalization, 1991 has acquired a revolutionary status as a time of change in the planning of India’s future. The present and the future of India’s growth and output is seen to be connected with Foreign Direct Investment and it was deemed necessary for promoting higher growth of output, exports and employment. Generally host countries purpose to attract foreign direct investment in their Industrial activities as a source of capital for the development of infrastructure. Especially, Foreign direct investment is needed for the growth of domestic trade, foreign trade for reducing imports and external borrowings and for home countries the purpose is to invest their capital in host countries with a view to generate income in return. It is also a source for spreading their business operations globally. The objective of this present study is to explore the overall sectoral impact of foreign direct investment on economic growth in India. The basic goal is to determine the policy options that are suitable for promoting development and growth in India.

Prior to 1991, the FDI policy framework in India was highly regulated. The investment process was plagued with many hurdles including unethical practices that became part of bureaucratic procedures. Under the deregulated regime, FERA was
consolidated and amended to introduce the Foreign Exchange Management Act (FEMA), 1999. The new Act was less stringent and aimed at improving the capital account management of foreign exchange in India.

Foreign Direct Investment (FDI) playing a key role in fostering development of a nation. FDI is considered as ‘Good Cholesterol’ as it grants the benefits enumerated earlier. A further benefit is that FDI is acknowledged to be ‘bolted down and cannot leave so easily at the first sign of trouble’ (Tanzi Vito and Coelho Isaias, 1991).

With the advent of globalization, developing countries, particularly those in Asia, have been witnessing a massive surge of FDI inflows during the past two decades. The likely impact on FDI inflows to India, as a result of increasing competition from another major emerging market economy, i.e., China, in the wake of its accession to the WTO (Sadhana Srivastava and Rahul Sen, 2004).

Like many developing countries, India too started liberalizing its foreign investment regime, especially since the beginning of the 'nineties. A variety of performance requirements on FDI, which characterized the earlier regime are no longer applicable. There is a need to examine the impact of these changes on (i) inflow of FDI and (ii) on the economy in general. (On going research project, sponsored by Department of Industrial policy and Promotion, 2007.)

Even though India has been a latecomer to the FDI scene compared to other East Asian countries, its significant market potential and a liberalized policy regime has sustained its attraction as a favourable destination for foreign investors.

FDI is expected to help the host developing countries to break out of the vicious circles of underdevelopment - low levels of productivity which leads to low wages, which in turn results in low levels of saving and investment. FDI should thus raise efficiency, expand output, improve competitiveness and consequently exports, and lead to higher levels economic growth in the host country. It is often assumed that (FDI) is an
important source of international technology transfer and economic growth for the host economy.

With these expectations, developing countries, understandably, have been competing for FDI by offering a variety of incentives on one hand and removing the policy and procedural hurdles on the other. Developing countries need enormous amount of financial resources for promoting the cause of their development. Generally, their domestic resources are not enough to meet these requirements thus the options left are: loans, Official development assistance (ODA) and Foreign Direct Investment (FDI).

FDI is now widely treated as an important resource for expediting the industrial development of developing countries in view of the fact that it flows as a bundle of capital, skills and sometimes even market access. Typically FDI brings with it, apart from the investible resources, the technology, management and corporate governance that are superior to the domestic economy. It brings in newer, better products, with gains for the domestic consumers. (Kumar Gulshan, 2008).

Foreign direct investment (FDI) flows to developing countries are supported with the view that FDI supplements domestic savings—thereby promote economic growth and employment, enhance host country exports, help transfer of technology, bring in management and marketing skills, generate competition in the economy, etc.

However, Government policies have been consistently aimed at providing a climate of confidence and security to foreign investors, who have enjoyed, for almost all purposes, the same treatment granted to domestic investors. In addition, of course, political stability has been an important magnet.

In an economic sense, FDI depends on different aspects of investments: the motive for investment (market-seeking, resource-seeking, and efficiency-seeking), type of investment (Greenfield or Brownfield), the sector of investment (manufacturing or services), and the size of multinational company or investor (Botric Valerija and Skuflic Lorena, 2006).
There is difference in the FDI performance among countries, it is necessary to understand how foreign investors choose their investment locations. The FDI usually goes to the countries where it is possible to combine the ownership advantages with the location-specific advantages of the host countries through internationalization advantages of foreign investments (UNCTAD 1998).

FDI represents an important source of finance for developing countries and transition countries but unfortunately most of the FDI inflows and outflows are concentrated within the developed countries. The FDI inflows to less-developed countries are associated with vertical investments. The vertical FDI takes place when a firm relocates only a part of its production process but not the whole production. The FDI inflows to developed countries are usually horizontal investments driven by market-seeking strategies, and they tend to increase the labor intensity of the home country domestic production (Mariotti et al. 2003 as quoted by Botric and Skuflic, 2006, p.362).

In recent years, the determinants of and motivation for the FDI in developing countries have changed in the process of globalization. The FDI is considered responsible for welfare increase in the host country due to advantages related to the introduction of new technologies and innovation, new managerial techniques, development of additional skills (Caves 1974, Perez 1997), increased capital, job creation and improvement of working conditions, and the development of the industrial sector in the host country (Haddad and Harrison 1993, Markusen and Venables 1999). Due to these facts, it can easily be understood why so many developing countries seek new ways to increase FDI inflows. In order to design appropriate economic policies to attract FDI, one must first find out what motivates the investors to seek other markets – in other words, what are the key determinants of the FDI.

Because the FDI is a rather complex economic category which depends on many factors whose relative importance changes as the economic environment evolves over time, it is possible that – because the economy of the host country changes as well as the
international environment evolves – the FDI factors also change (UNCTAD 1998). Even though traditional determinants and the types of the FDI associated with them have not disappeared with globalization, their importance is declining. For example, one of the most important traditional FDI determinants, the market size, has decreased in importance, while at the same time some new determinants became prominent. This reveals that the investors’ motives are changing, and consequently countries must seek new ways to attract FDI.

China has proved itself as a front runner in inward FDI performance and India has been detected as underperformer in this regard. The reasons responsible for this can be attributed to redtapism and bureaucratic procedures, lack of competitive environment and inadequate infrastructural facilities (Kumar Gulshan et.al 2008), macro economic instability, heavy bureaucratic requirements structural barriers, corruption and political instability (Ulussever Talat 2008).

Even Indian companies that invest in China find the climate more suitable than back home. The South Asian region can make progress in the sphere only when it will be able to fulfill its internal deficiencies whether economical (mainly infrastructural), political or social.

Globalisation helps economies gain through international investment. A World Bank survey shows sound investment climate helps countries gain more from globalization and proves how those countries that integrate with the global economy have grown faster than others (World Bank Investment Climate Survey as quoted by Ulussever Talat, 2008, P.51).

With the experiences of several financial crises in the emerging markets FDI has proved to be durable during financial crisis. The durability of FDI during financial crisis was also proven during financial crisis was also proven during the East Asian crisis of 1997-98, Mexican crisis of 1994-95 and the Latin America debt crisis of the 1980s. Moreover the recent financial crisis in 2009 followed by a modest recovery in the first
half of 2010, sparking some cautious optimism for FDI prospects in the short term. In the longer term, the recovery in FDI flows is set to gather momentum.

There are some major changes in global FDI patterns that preceded the global crisis and that will most likely gain momentum in the short and medium term. The relative weight of developing and transition economies as both destinations and sources of global FDI is expected to keep increasing. These economies, which absorbed almost half of FDI inflows in 2009, are leading the FDI recovery.

In India any inflow of FDI is recorded with the RBI and is reported by the Department of Industrial Policy & Promotion (DIPP) in the form of fact sheets, newsletters or annual issues. There are three primary institutions in India that handle FDI-related issues: the Foreign Investment Promotion Board (FIPB), the Secretariat for Industrial Assistance (SIA), and Foreign Investment Implementation Authority (FIIA).

Foreign investment is permitted in virtually every sector, except those of strategic concern such as defence (opened up recently to a limited extent) and rail transport. Foreign companies are permitted to set up 100 per cent subsidiaries in India. No prior approval from the exchange control authorities (RBI) is required, except for certain specified activities. According to the current policy, FDI can come into India in two ways: i) Automatic route ii) Prior Government Approval route.

Foreign direct investment has traditionally been controversial receiving both praise and condemnation (Tanzi vito and Coelho Tsias, 1991). Some claim that foreign direct investments may serve as “engines of development”, helping developing nations catch up with the developed nation. Others see foreign investors as promising virtually anything in order to secure a share of economic pie in developing nations (Barnet and Muller, 1974). Confronted with economies that are plagued by severe difficulties, they often see foreign direct investment as panacea. Hence, many developing countries turn to developed capitalist countries for the investment that they hope will lead to growth and prosperity.
Countries of world, particularly developing countries are varying with each other to attract foreign capital, particularly foreign direct investment (FDI) to boost their domestic rates of investment as also to acquire new technology and managerial skills (Sury Niti, 2008). Encouragement of foreign direct investment (FDI) is an integral part of the economic reforms process of most developing nations because it is seen as an instrument of technology transfer, managerial skills, augmentation of foreign exchange reserves and globalization of economy.

Like aforementioned, attracting FDI has become a fierce competition among host countries in the last two decades. Foreign Direct Investment (FDI) inflows have been expanding at a faster rate than ever with increasing globalization. International statistics show that the amount of FDI inflows into the developing countries increased remarkably in the 1990s and peaked at US$ 18 billion in 1999 to $548 billion in 2009. (Ulussever Talat, 2008). Moreover, the total inflows worldwide increased to over $1.2 trillion in 2010, are expected to pick up further to $1.3 – 1.5 trillion in 2011, and head towards $1.6 trillion in 2012 (UNCTAD WIR 2008).

Over the last decades, inflows of foreign direct investment (FDI) to developing countries have soared (Razafimahefa Ivoahasina and Hamori Shigeyuki, 2005). The investment of today will become a value added of tomorrow (Dominese Giiorgio).

The reforms and liberalization polices undertaken by the Indian government since 1991 have boosted FDI inflows into India. The amount of foreign direct investment (FDI) in the Indian economy increased considerably over two decades and reached a historically highest level in the year 2001 (Ulussever Talat, 2008, UNCTAD WIR 2010).

A number of studies in the recent past have highlighted the growing attractiveness of India as an investment destination. According to Goldman Sachs (2003), the Indian economy is expected to continue growing at the rate of 5 per cent or more until 2050. According to the A.T. Kearney (2007), India continues to rank as the second most attractive FDI destination, between China at number one and the United States at
number three. India displaced the United States in 2005 to gain the second position, which it has held since then. FDI inflows in 2006 touched $19.6 billion and in 2007, total FDI inflows in India stood at $23 billion, showing a growth rate of 43.2 per cent over 2006. In 2008, total FDI inflows into India stood at $33 billion.

India and China are the two emerging economic giants of the developing world, both situated in Asia with 37% of world population (Asian Development Outlook 2005) and with more than 8% growth in their respective GDP of their economies (World Development Report 2006). Both the economies have immense natural resources, skilled and unskilled, cheap but quality labour force, huge domestic market and above all the relatively stable political environment. Both the economies hence have vast potential to attract Foreign Direct Investment (FDI) to serve the local market and to become a more important part of the global integration.

OECD rightly observed, “The effective and thorough implementation of China’s WTO Commitments would be critical to its success in achieving its potential in luring FDI”. Whereas India is still far behind China in becoming the attractive FDI destination, for the obvious reason such as power shortage, poor infrastructure, security consideration, absence of an exit policy etc. If India has to reach its target of attractive more FDI for its development, The Indian Policy makers should understand that the good intentions and mere plan layouts alone are not sufficient condition, but a bold aggressive third generation reforms is the need of the hour. Only then one can expect India to attract FDI to its potential and can become a popular investment destination as China (Keshava).


1.2 STATEMENT OF THE PROBLEM:

There are various studies which have brought to light that the inflow of foreign direct investment has been one of the key indicators of growth of a nation. When the reforms began in 1991 it was inevitable that there would be a discrepancy as various sectors have different characteristics and procedures. The reforms and polices on Foreign Direct Investment have trickled down to various sectors in different speed and effectiveness.

It is postulated that Foreign Direct Investment in general has contributed significantly to the development of the sectoral and overall growth of the host countries. India is the second most favoured destination of Foreign Direct Investment next only to China. Since liberalization India has opened the flood gates of its investment regime and many MNCs sees this opportunity to make gains in the world market. India has made many policy changes to woo Foreign Direct Investment as an alternative source of investments. The registered growth rate of 9 per cent is a result of the sectoral growth to which the contribution of Foreign Direct Investment is no less significant. However, the
lop sided development of the various sectors has come to light in the stagnation and the crisis in the agricultural sector.

Hence the present study will probe into the imbalance growth of various factors in the growth of various sectors in the wake of huge Foreign Direct Investments. Not many studies are available in the literature which made a thorough investigation on the impact of Foreign Direct Investment in the post liberalization and in the current economic scenario of the country.

Previous studies have made important contributions to this challenging problem, however, none of the studies appear to have completely accounted for the effects of Foreign direct investment on sectoral analysis. A pioneering effort in this direction is described by Rothgeb, Jr. (1984), Mathiyazhagan M. K (2005), Bang Vu Tam and Ilan Noy (2007), Mathiyazhagan. M. K and Sahoo. D (2008) highlighting the need for additional investigation of the system properties when the full set of interacting factors are incorporated in the model.

Similar views are presented by Chenery and syrquin (1975) and Bornschier (1981). Chenery and syrquin maintain that foreign direct investment (FDI) in modern sectors makes techniques and machinery available that will enhance agricultural productivity by making it easier to market goods. Bornschier sees flows of foreign direct investment (FDI) result in growth because new facilities are built, new products are introduced, and new jobs are created, but it last only for a while; that is short – term effect on growth in modern sectors. Contradictory views are over the long – run, however, the initial growth in these sectors dies out, and stagnation or decline sets in regarding overall growth: local competitors are destroyed, inappropriate technology destroy jobs, and multinational investors shifts their resources and attention to markets in other countries (Rothgeb . John M. Jr, 1984).

The present study is an attempt to probe into the impact of foreign direct investment (FDI) inflows on the overall and sectoral growth of Indian economy during
the post – reform period. The first chapter includes the introduction overview, Objectives, Hypothesis, Methodology, Model and limitations. The rest of the study is organized as follows: The next chapter provides the Literature Review. Chapter 3 discusses the Theoretical and Policy Framework of FDI. In chapter 4 results are Analyzed and Discussed and finally chapter 5 concludes the study with Findings and Suggestions.

The study seeks to make a comparative study of policies and procedures and actual inflows of FDI in select sectors in India. The study has been taken up for the period 1991-2008.

1.3 OBJECTIVES

The present study makes a modest attempt by providing a comprehensive analysis of the overall and sectoral growth effects of FDI on Indian economy. The following objectives are framed for the purpose of the present study.

1. To identify the total FDI inflows into India in the post liberalisation period.
2. To find out sector-wise FDI inflows in India.
3. To assess the sectoral distribution of FDI.
4. To compare the overall and sectoral distribution of FDI.
5. To examine the impact of FDI inflows on the growth of various sectors of the Indian economy.
6. To assess the performance and problems of FDI in India.
7. To suggest measures for policy making.
1.4 HYPOTHESES

In tune with the objectives framed, the following hypotheses were constructed.

1. There exists a positive relationship between FDI inflows and overall economic growth of India over the period 1991-2008.
2. There exists a positive relationship between FDI inflows and growth in various sectors of the economy over the period 1991-2008.
3. There exists a favourable investment climate for FDI inflows into India.

1.5 DATABASE AND METHODOLOGY

A number of factors led to increased efforts by developing countries to attract flows of Foreign Direct Investment. This study examines the sectoral impact of foreign direct investment on overall growth in India. The present study makes use of secondary source of data collected from the publications of Government of India, Reserve Bank of India, Ministry of Industry and Commerce, WIRs, WDIs, World Bank, and IMF, UNCTAD, WIRs, Centre for Monitoring Indian Economy (CMIE), other than books, Journals and Periodicals. The reference period of this study relates from 1991 to 2008. Relevant statistical techniques using SPSS, especially multiple regression and Partial correlation have been used in the study along with simple ratios and averages.


The dependent variables selected for empirical testing were overall GDP and sectoral GDP. Seven variables were examined as independent or control variables. They
are: (i) Total Foreign Direct Investment Inflows \{\text{TOTFDIIF}\} (ii) Foreign Direct Investment Amount Approved \{\text{FDIAA}\} (iii) Population \{\text{POP}\} (iv) Growth of Population \{\text{GPOP}\} (v) GDP Per capita Income \{\text{GDPPCI}\} (vi) Gross Domestic Capital Formation \{\text{G.D.C.F}\} (vii) Gross Fixed Capital Formation \{\text{G.F.C.F}\}. In addition to foreign direct investment (FDI), variables relating to domestic investment, population and wealth are included in the analysis. Dependent and independent variables were briefly explained below:

(i) **GROSS DOMESTIC PRODUCT:**

Gross Domestic Product, is defined as the total value of all goods and services produced within that territory during a given year. GDP is designed to measure the market value of production that flows through the economy.

(ii) **TOTAL FOREIGN DIRECT INVESTMENT INFLOWS :**

Foreign direct investment (FDI) Inflows are the value of new capital introduced into country during a specific period of time.

(iii) **FOREIGN DIRECT INVESTMENT AMOUNT APPROVED :**

Foreign direct investment (FDI) Amount Approved is the amount approved by a country during a financial year to be invested by the foreign investors in their country.

(iv) **POPULATION :**

Population is the estimated aggregate population of the country according to various census reports.
(v) **GROWTH OF POPULATION:**

Growth of Population refers to the number of individuals in a population increase in a given time period as a fraction of the initial population.

(vi) **GDP PER CAPITA INCOME:**

GDP Per capita Income or income per person is a measure of mean income within an economic aggregate, such as country or city.

(vii) **GROSS DOMESTIC CAPITAL FORMATION:**

Gross Domestic Capital Formation is the addition to the total capital stock of a country’s own territory during a given year. It is an index of the level of investment in the economy.

(viii) **GROSS FIXED CAPITAL FORMATION:**

Gross Fixed Capital Formation is a flow value. It is measured by the total value of producer’s acquisitions, less disposals of fixed assets during the accounting period plus certain additions to the value of non-produced assets realized by the productive activity of institutional units.

In short, Gross Fixed Capital Formation is a measure of gross net investment in fixed capital assets by enterprises, government and households within the domestic economy, during an accounting period such as quarter or a year.

### 1.6 MODEL

The econometric model used here is

\[
\text{Overall GDP} = a + b_1 \text{TOTFDIIF} + b_2 \text{FDIAA} + b_3 \text{POP} + b_4 \text{GPOP} + b_5 \text{GDPPCI} + b_6 \text{G.D.C.F} + b_7 \text{G.F.C.F} + E
\]

The model finds out the relationship between dependent and independent variable.
1.7 LIMITATIONS

The present study is limited to the overall and sectoral growth and analyses of FDI inflows into India. Outflows are not the part of this study. Only cumulative FDI inflows data is available, year wise FDI inflows data on sector wise and country-wise is lacking.