Chapter II

REVIEW OF LITERATURE

Liberalisation of foreign policy of India since 1991 has played a vital role in the reform perspective of Indian Economy and has increased the volume of investment, level of production, improvement of technology, higher level of employment generation and thereby increase access in the Global market. The policy now allows 100 per cent foreign ownership in a number of industries and obtaining permission has greatly been simplified. Industries are eligible for automatic approval upto some extend of foreign equity viz. 55, 74 and 100 per cent the potential foreign investors can invest within these limit in India and register with the Reserve Bank of India. For higher level than the automatically permitted listed industries can directly apply to the Foreign Investment Promotion Board of India (FIPB) which may be immediately considered for their investment in India. In 1993, foreign institutional investors had been allowed to purchase the shares of listed Indian companies in the stock markets. These types of activities have created a highly competitive environment in Indian industries since 1991.

A large numbers of research papers and articles have been published about Foreign Direct Investment in India. Reviews of a
selected authors are discussed here which may be very useful for the understanding of the present study.

Changing contours of capital flows to India

According to Mohan (2007) the Indian experience with capital flows during the period 1950s to the first decade of this century reveals a paradigm shift from a prolonged period of capital scarcity to one of surplus. The key structural aspects volatile pattern of inflows. The key structural aspects include a significant shift from official to private capital flows and from debt to non-debt flows. Non-resident Indian deposits show considerable sensitivity to interest and exchange rate fluctuations. The corporate preference for overseas borrowings is predominantly influenced by domestic activity; but the persistence of interest rate arbitrage and global credit market shocks also have a significant impact. Foreign institutional investment inflows and stock prices have a bidirectional causal relationship with a time varying nature of the stock price volatility. Volatile capital flows rather than trade flows seem to drive real exchange rate movements with consequences for the real economy.

The trade channel was considered as the traditional mode of the integration of the global economy. However, international mobility of capital, particularly since the 1970s, has provided a new dimension to the concept of openness and economic integration. The
liberalization of India’s external sector and increasing integration into the global economy in the 1990s and the current decade have resulted in the relative dominance of the financial channel over the conventional trade channel. While the aggregate trade flows increased from 10 per cent of the gross domestic product (GDP) in the 1970s to 28 per cent in the first decade of the 2000s, gross capital flows (inflows + outflows) increased sharply from 4 per cent of GDP to 30 per cent during the same period. These developments were underpinned by a sustained momentum in domestic real activity, corporate sector restructuring, a positive investment climate, a long-term view of India as an investment destination and favourable credit conditions in the global market. However, the absorption of capital flows has remained low with a moderate level of the current account deficit (CAD) in the 1990s and the current decade and the consequent build-up of foreign exchange reserves.

Against the above backdrop, large capital inflows have implications for the real sector of the economy through interest and exchange rate channels. The excessive capital inflows beyond the absorptive capacity, in conjunction with workers remittances and software exports, could have the potential for creating an overvalued exchange rate and the consequent erosion of long-term competitiveness of the traditional goods and services sectors – the Dutch disease phenomenon. It is argued that given the employment
dimensions of the traditional sectors of the economy, the Dutch disease syndrome is managed by way to reserve management and sterilization, the former preventing excessive nominal appreciation and the latter preventing higher inflation (Mohan, 2007). Some of the concerns emanating from the expansionary phase of the capital flow cycle have abated with a reversal in the cycle since the mid-2008. However, a sudden shift from expansionary to contractionary phase of the capital flows cycle to emerging market economies (EME’s) and India has potential costs in terms of financial market instability and an adverse impact on investment and the real sector of the economy. Thus, the rapid movement of capital flows and high volatility associated with capital flows is a challenging issue for macroeconomic management.

The literature on international capital flows reveals that mobility of flows is associated with various benefits and costs. In terms of benefits to the financial markets, the increased mobility of capital contributes to the development of markets in terms of liquidity and price discovery. At the same time, as evident from various crises across countries during the 1990s, an increase in volatility of capital flows poses several risks to the financial markets and the real economy. The surges in capital flows to the EME’s and the associated overshooting of the exchange rate and the currency crises have led to the proliferation of literature on the subject. It
broadly focuses on two major implications of volatile capital flows, i.e., for macroeconomic stability and financial stability. Short-term volatile capital flows have a significant influence on asset prices, exchange rate, interest rate, consumption, investment, trade and thus, the aggregate demand, rendering some of the earlier anchors of monetary policy formulation possibly obsolete. The aggregate demand, in turn, affects output and prices, the two key policy objectives.

**Policy Shifts, Magnitude and Composition of Capital Flows**

A historical account of the policy approach to international capital flows to India suggests that begging with the 1950s, a complex maze of controls was imposed on all external transactions between residents and non-residents independent of trade or other policies. In fact, a significant part of the control regime to subserve the developmental efforts of the planning era was built upon the framework of war-related controls, which was put into a more rigorous framework through legislation in 1973 due to fears of capital flight (Reddy, 2000). Thus, external financing was done dominantly through reliance on official flows from the 1950s through the 1970s. The decade of the 1980s, however, heralded a regime shift in capital flows to India with ascendancy of private capital flows in the form of external commercial borrowings (ECBS), non-resident Indian (NRI) deposits and short-term trade
credit. The liberalization of the foreign investment regime in the 1990s heralded a further shift in the capital flows to India, particularly the equity flows. In the aftermath of the balance of payments (BOP) crisis of 1991, policy actions were initiated as a part of the overall macroeconomic management to achieve stabilisation and structural changes.

The external sector policies designed to progressively open up the Indian economy formed an integral part of the structural reforms. In the 1990s, the lessons drawn from managing the crisis led to external sector policies that emphasized consolidation of external debt and a policy preference for non-debt creating capital flows. The key policy responses to capital flows have been in the form of a strong hierarchy in the sources and types of flows, liberalization of inflows relative to outflows, but freeing up of all the outflows associated with inflows and a shift from administrative or quantity-based controls to price-based measures. The anatomy of the instruments of controls reveals that restrictions on capital inflows are a mix of both quantity and price, taking into consideration the hierarchy of capital flows. However, the controls on outflows are mainly quantity-based. The gradual withdrawal of restrictions on capital inflows and the liberalization of outflows seem to have reinforced capital inflows.
The current global financial crisis has, however, highlighted the strong sensitivity of global capital flows to financial shocks and swift changes in the perception of risk towards EME’s. The sudden reversal in the capital flow cycle to India led policy responses in the form of an upward adjustment of the interest rate ceiling on NRI deposits, substantial relaxation in the ECB’s regime for corporates, allowing access to ECB’s to non-banking financial companies and housing finance companies and relaxation in the interest rate ceilings for trade credit. Thus, the emphasis shifted from the policy dealing with consequences of heavy inflows to sudden reversals of such flows and the potential volatility. Thus, the inherent volatile nature of capital flows to EMES underlines the importance for an active capital account management.

**Shift from Official to Private Debt Flows**

*Mikesell (1968)* it is argued that foreign aid can facilitate economic and social transformation by overcoming temporary shortages in specific human and material resources, promoting strategic activities, inducing and facilitating critical government policies and providing working capital for carrying out programmes involving a transformation of the structure of the economy. A time series analysis of several countries in Asia, including India, Pakistan and China, suggests that aid contributed to growth both in poor and middle income countries (*Krueger, 1978; Islam, 1992*). There is no
evidence to suggest that countries that received a large amount of external aid have performed poorly (apart from countries suffering from civil or external conflicts) and the empirical evidence that high aid levels exert an independent negative impact on governance is unconvincing (World Bank, 2003). It is often argued that governments of the aid-receiving countries divert foreign aid from intended purposes to various unproductive uses and/or to support general government expenditure. Various studies have indeed found fungibility of foreign aid. Despite differing viewpoints, the role of external assistance in the development process of developing countries cannot be overemphasized.

External assistance in the form of concessional, non-market-based finance from bilateral and multilateral sources remained as a mainstay of the capital account of India’s BOP till the early 1980s. Towards the end of the 1970s, the concessionality in the aid flows dwindled. Thus, with the rising external financing requirements in the 1980s and the recognition that reliance on external assistance was not favourable, there was a shift in the overall approach towards aid flows. In the recent decades, the policy towards management of external liabilities has changed and the initiative is towards attracting private capital flows, especially non-debt creating direct investment inflows. Thus, the share of official assistance in total capital flows to
India has consistently declined from 33 per cent in the 1970s to about 6 per cent in the first decade of this century.

In the 1980s, a widening CAD, increasing financing requirements and diminishing role of official aid led to a shift in the policy choice towards commercial borrowings from international capital markets. The recourse to commercial borrowings by the Indian corporates, though began in the 1970s, remained modest due to the dominance of external aid. The commercial borrowings were, however, regulated by an approval procedure subject to conditions on cost, maturity, end use and ceiling. In the second half of the 1980s, financial institutions and public sector undertakings increased their participation in the international bonds market, consequently the share of ECB’s in net capital flows to India more than doubled to 27 per cent in the 1980s from that in the 1970s. Following the BOP crisis of 1991 and downgrading of sovereign ratings, firms’ access to global markets virtually dried up.

Thus, a prudent external debt management policy was pursued to bring the external debt to a comfortable level. The ECBS rose significantly in the latter half of the 1990s responding to the strong domestic investment demand, favourable global liquidity and credit rating, lower risk premia on EME bonds and an expansionary phase of the global capital flow cycle. During this period, ECBS
constituted about 30 per cent of net capital flows to India. In the subsequent period (late 1990s and the early years of this decade), the demand for ECB’s remained subdued due to a host of factors such as the global economic slowdown, reversal of the cycle of capital flows to EMES and moderate domestic demand. The period beginning 2003 marked the resumption of debt flows to EMES, which was a combined outcome of a higher interest rate differential, robust growth expectations and a low risk perception. During this period, Indian corporates also increased their resource to ECB’s, which contributed to about 25 per cent of the net capital flows to India.

Capital Account Management and Sterilisation

The literature suggests that initial policy response to deal with volatile capital flows has been market intervention combined with sterilization. Sterilisation is found to have either halted or delayed appreciation of the domestic currency, but not effectively check inflows, mainly due to the persistence of interest rate differential. Direct controls on portfolio inflows in particular have been found to be effective only in limited cases, that too for a short period and circumvented through financial engineering. Therefore, capital controls have been interpreted as a short-term palliative within the gamut of policy options. While the mature and well developed financial markets absorb the risk associated with exchange rate fluctuations with limited spillover to the real activity, the developing
countries with underdeveloped financial markets and lack of resilience to absorb the shocks have inherently higher volatility arising of external shocks. Thus, large swings in capital flows over a very short period of time impose significant adjustment costs and large output and employment losses on the EMES (Mohan, 2009). Exchange rate volatility arising of volatile capital flows has significant adverse consequences, particularly for countries which specialize in labour-intensive and low-intermediate technology products in an intensively competitive global market.

During the expansionary cycle of capital inflows to India, a clear movement of higher trade deficit and appreciating real effective exchange rates (REER) was evident. Particularly since 2004-05, despite a large trade deficit, a rise in capital inflows led to appreciation of the real exchange rate. Capital flows have emerged as the key driver of the REER movements rather than the movements in the trade or current account. The contractionary phase of capital inflows has been associated with a depreciating REER. Thus, the volatile movement in capital flows to India, beyond its implications for monetary management, poses challenges for trade competitiveness and the real economy.

The analysis of capital flows to India from the 1950s to the first decade of this century reveals a structural shift in the 1980s
from the dominance of external assistance to the primacy of private capital flows. The consequent effects of the expansionary phase in capital flows were evident in the overall movement in the REER driven by capital flows rather than the trade deficit, the expansion in domestic liquidity and associated sterilization costs. A sudden shift in the risk perception to EMES emanating from the global financial crisis was evident in the reversal of the capital flow cycle to India in 2008 with challenges of large inflows giving way to the concerns of sharp reversals and their implications for the domestic financial market stability and the real sector. Second, the decline in debt flows reflected the policy-induced changes in the composition of the capital account in favour of non-debt flows. Reflecting the service-led growth of the economy and the comparative advantage in trade in services, FDI inflows to India have been increasingly concentrated in the services sector. Another key feature is that such inflows have displayed stability even during the various episodes of major global financial shocks.

Third, responding to the policy changes in favour of progressive liberalization of outward investment, Indian corporates have expanded with an increasing concentration into trading and non-financial services – a shift from the manufacturing. Fourth, FII investments are characterised by higher volatility and sudden reversals. The causality analysis showed that FII flows and the stock
market have a bi-directional causal relationship with time varying nature of the stock price volatility. Fifth, while the overseas commercial borrowings are significantly influenced by the pace of domestic activities, interest rate arbitrage also plays an important role. However, the current global financial crisis shows that the global credit market shocks have a significant impact on raising ECBS. Sixth, NRI deposits display a sensitivity to interest and exchange rate expectations, which builds in an element of instability to such inflows.

Gupta, in his book “Post reform India; emerging trends” mentioned that Foreign Direct Investment generates employment, foreign exchange and taxable income for the host county. In addition to that the presence of foreign investment in the county could raise the productivity of locally owned firms.

According to Prof. Nasim A. Zaidi one of the problem associated with foreign capital in India in recent year is that large amount of capital is coming in the form of portfolio investment rather than in the form of foreign direct investment. As far as the aspect of disciplining foreign capital is concerned only legislation is not adequate to achieve the objective. The state requires economic power – a production base and command over capital. Public sector should fulfill, at least, three major requirement. Namely (i)
Productive Efficiency (ii) To generate a re-investible surplus and (iii) most important of all, it should become instrument in the hand of the state to demonstrate how capital under social control can be mobilized. These are the ways to discipline capital and this is how China is dealing with foreign capital.

According to Goel for attracting more Direct Foreign Investments like China, India has to intensify reforms process so that it will percolate down to lower levels of geographical units like districts and mandals. In this context it is pertinent to note that the leader of Japanese delegation visited India. Conceded that there is a “great gap” between the average Japanese business man’s perspective of India and the prevailing reality. To attract more FDI the government should also introduce reforms in public administration to cut short bureaucratic hurdles to be eliminated so that it will be possible for India to get higher foreign direct investments. Upgradation of production technologies are the top priorities of foreign direct investments and this exercise is to be taken in the primary, secondary and tertiary sectors of India on higher scale, which will benefit in increasing employment prospects in India. Ultimately the causal factors of growth are valued added activities, upgradation of technologies in the sectoral economies and better environment for attracting higher foreign direct investments.
FDI in Higher Education – Official Vision Needs Correction

Rajesh Kumar Sharma discusses that the decision of the government of India to allow foreign direct investment in higher education is based on a consultation paper prepared by the commerce ministry, which is marked by Shobby arguments, perverse logic and forced conclusions. This article raises essentially four issues which need critical attention: the objectives of higher education, its contextual relevance, the prevailing financial situation and the viability of alternative to FDI.

The first issue is addressed in the light of four requirements one of - which strangely - is improved literacy. A link is suggested between “market-complementary arrangements in education” in the developed countries and the high levels of literacy that obtain there. Improved literacy has all along been tagged with better primary education, yet the consultation paper expects to somehow raise the literacy levels with FDI in higher education.

The second requirement is to contain the outflow of money to other countries in the shape of fees and related expenditure. The paper does not, however, rely on any data based study of the courses and institutions chosen by the Indian students abroad. It does confront the reality that a very large number of students go abroad to work and earn not to get education at some internationally reputed
university. It is also silent on how the fees received by foreign-based universities in India will be utilized.

The third requirement, based on a **McKinsey-NASSCOM** study, is the need to train a large number of graduates to handle the expected bonanza of offshore business and to work for multinational companies. Most of these “millions” of jobs will be in the information technology (IT) and information technology enabled services (ITES) sectors and will certainly not require Harvard-standard education. Moreover, let us not expect a few Harvard and Oxford-like satellite campuses in India to turn out graduates in millions over the next five or six years.

The fourth requirement arises from the dubious ambition to join the league of education-exporting countries like the US, UK and Australia. The idea that we will import education as just another commodity. Also, we should not forget that the best universities in the west do not treat education as a business and may not be interested to come to India “to do business”. In the name of the best, let us not open our gates to unscrupulously mercenary corporate interests. In any case, have we given a chance to our own universities to perform at their best? The Indian Institutes of Technology (IITs) and Indian Institutes of Management (IIMs) did come up without FDI.
To say the least, these four requirements only constitute short-term objectives and are formulated in terms of current trends in world business. But higher education also needs long-term objectives and a broad vision in tune with the projected future of the country and the world. Its contextual relevance in the case of India has to be conceived in terms of our civilisational history and the contribution we wish to make to the future of humanity. Unfortunately, the consultation paper makes no efforts to understand the peculiarities of the Indian situation in the national and global contexts.

Nagarajan (2005) says in his paper the government needs to clarify the confusion surrounding the promoter holding in private banks. It is ironical that when the government is thinking of 74 per cent FDI in private banks the Reserve Bank of India has issued draft norms restricting promoter holding to 10 per cent. RBI recently proposed that no single entity or a group could hold more than 10 per cent of the paid-up capital in a private Indian bank. It has also capped the holding of one private bank, including foreign ones present in India, in another private bank at 5 per cent, besides asking promoters to reduce their holding to 10 per cent in three years. If banks were to follow the first draft guidelines, a number of private banks would have to realign their shareholding pattern. The United Forum of Bank Union has threatened to go on strike to protest centre’s map for banking sector reform. The forum in its recent
Bangalore meeting, expressed its concern that allowing 74 per cent FDI would result in foreign capital taking over country’s private banks and controlling their huge resources.

Indian government keep abreast of global changes through initiation of prompt reform measures, attracting FDI on par with other developed and developing nations become a difficult task, especially in competing with country like China which is number one most favoured and ultimate destination for foreign direct investment, and loosing its pride as a number three on FDP map. Therefore in a clear infrastructure was most critical area where huge injection of funds was required. In order to gain momentum, banking sector should take a view of uniform legislation for the public and private sector banks. While public sector banks are ruled by the National Banking Act, SBI by the SBI Act and private sector banks by the companies Act, there is need to have uniform act which is applicable to all. The blue print to the banking sector reforms should also address the issue of more autonomy to the public sector banks especially in relation to opening of branches, says Kohli Chairman and MD of Punjab National Bank.

Narayana (2006) says in his paper inflow of FDI in Karnataka that no consistent trend either increasing or decreasing is evident between FDI and economic growth and between FDI and
exports, during 1993-94 to 2003-04. However, a positive correlation is evident between FDI inflows and economic growth since 2001-02 and between FDI inflows and total exports before 2001-02. This suggests a need for periodization for the study of relationship between FDI and economic growth and FDI and exports, in the State since 1991.

FDI inflows, along with exports, have been contributing to the process of economic globalization. This process is mainly driven by the ICT sector. In general, the remarkable performance of ICT sector is accountable for (a) availability of low cost, highly skilled, communicative and mobile technical manpower, (b) globally competitive management and practices, (c) promotional and developmental policies and programs by way of providing fiscal and financial incentives and concession. Provision of infrastructure facilities and good governance measures and (d) historical and natural cluster of ancillary industries in electronic and electrical sector. Thus, these factors need to be strengthened as strategies for attraction of larger FDI inflows in future.

Karnataka’s experiences in building databases, identifying investment opportunities, formulating investment promotion programmes under the general and sector-specific industrial and infrastructure policies, constructing performance indicators for
competitive attraction and deriving implications on regional economic growth, exports and globalization are of relevance and applicability for other states in India. In the same way, subject to the comparability of economic structures, Karnataka’s experiences are relevant for sub-national FDI promotion policies in other developing countries. In fact, the relevance and applicability above establish a basis for comparative studies between Karnataka and other regions in India and elsewhere in the developing world.

Kaur Mandeep et al. (2004) said in their paper that FDI has always been a subject of intense debate. About a decade back FDI was not easily welcomed by developing countries. Developed countries have been experiencing inflow but in recent times there is sudden increase in the level of the FDI inflow. The case and consequences of FDI inflow indicates that large part of economic growth of developed countries is attributed to the level of FDI inflows. In a most liberalized economic environment, the flow of foreign direct investment appears to follow a law of gravitation. i.e. free flow of capital from capital surplus country to capital deficient country. Given the intense competition among the countries for attracting FDI inflows in the recent period, the ability of South Asian countries as a group to expand their share in developing world is indeed commendable. However, much of the increase in the inflows to the region has been accounted for my India. This is because of the

**Foreign Direct Investment in Retail**

**EAS Sharma (2005)** says in his paper “Need for Caution in Retail FDI” though the government has been considering opening up the retail business to foreign direct investment for some time, it must first examine the constraints faced by traditional retailers in the supply chain and institute a package of safety nets as Thailand has done, India should also draw lessons from the restrictions placed on the expansion of organized retailing, in terms of sourcing capital requirement, zoning, etc., in other Asian countries. This article comments on the retail FDI report that was commissioned by the department of consumer affairs and suggests the need for a more comprehensive study.

India’s retail trade is largely in the hands of the unorganized sector. Only recently, large supermarkets, departmental stores and luxury shopping malls have started making their entry in some cities.
These are owned and managed by Indian promoters, though some foreign retailers have made a backdoor entry through franchises and export oriented whole sale activity.

For some time, the government has been considering opening up the retail business to foreign direct investment (FDI). FDI is indeed a sacrosanct world, the most frequently chanted mantra of economic reform in India since 1991. While many other sectors have already been exposed to FDI, due to opposition from the Left and the various trade associations, the retail sector has had to wait for quite some time. It is perhaps against this background that the department of consumer affairs promptly commissioned Indian Council for Research on International Economic Relations (ICRIER) to carry out a study on foreign investment in the retail sector. So that the government may take a early decision. The outcome of that study is the report on FDI in the retail sector. The report contains several recommendations of FDI in the retail sector. The major recommendation is that the India retail sector should be opened up to 49 per cent FDI straightaway and 100 per cent later on. The strategy of opening up should be checked up by appropriate reform measures in other sectors. Within the WTO framework, unilateral liberalization should precede multilateral commitments. Evidently, these recommendations will have far-reaching implications for the traditional retailers in the country.
To appreciate the arguments in support of the recommendations, one need to understand the nature of retailing in India and consider the inputs and the analysis that went into the different chapters of the report. A person selling fruits and vegetables on a cart or a more stationary wayside shopkeeper selling grocery articles and food items represents the majority of retail traders in India. Each of these vendors usually occupies not more than 30-40 square feet of space at best, less than the parking lot appropriated by a customer’s automobile in the sprawling frontage of a modern departmental store. But, these faceless, voiceless small-time traders, around 15 million in all, constitute 98 per cent of the country’s retail business, contribute around 10 per cent of GDP and account for 6-7 per cent of total employment. Had all the rules and regulations relating to land use, workers rights, quality standards, taxation, etc. been strictly enforced, these small traders would never have survived. Being unorganized, they have no access to bank loans and are constantly under threat of eviction from the petty bureaucracy of the government.

It is against the above background that the report and its recommendations need to be evaluated. Since 98 per cent of retailing in India is in the unorganized sector, the department of consumer affairs or any other concerned ministry should commission a more detailed study of that sector and analyse the impact of expansion of
the organized sector, as well as the implications of the entry of foreign players for both organized and unorganized sectors within the country. The study should focus on the direct and indirect employment potential of each of these sectors, in relation to the magnitudes of investments required. The employment and investment implications may vary from sector to sector, region to region and rural to urban. Such a study should necessarily over all segments of the supply chain, so that the government may have a better appreciation of the total benefits and costs, in the short term as well as in the long-term. Before opening up the retail sector, the regulatory structures in the related sectors need to be strengthened, as otherwise, foreign players as well as the larger domestic retailers could exploit the traditional retailers. It may not be desirable to open up retail to FDI until reforms in the related sectors are undertake and competitiveness of domestic retailers in enhanced.

Meanwhile, the government should examine the constraints face by traditional retailers and other players in the supply chain and institute safety nets as has been done in Thailand and other countries in Asia. Most Asian countries have put in place restriction in terms of sourcing, capital requirement zoning etc. in order to regulate the expansion of organized retailing. India should draw lessons from this.
The retail sector is a highly sensitive one because of its immense contribution to the economy. Decisions regarding FDI in this sector should not therefore be taken in haste.

**Foreign Direct Investment**

India has been ranked at the second place in global foreign direct investments in 2010 and will continue to remain among the top five attractive destinations for international investors during 2010-12, according to United National Conference on Trade and Development (UNCTAD) in a report on world investment prospects titled, ‘World Investment Prospects Survey 2009-2012.

The 2010 survey of the Japan Bank for International Cooperation released in December 2010, conducted among Japanese investors, continues to rank India as the second most promising country for overseas business operations.

A report release in February 2010 by Leeds University Business School, commissioned by UK Trade and Investment (UKTI), ranks India among the top three countries where British companies can do better business during 2012-14.

India is ranked as the 4th most attractive foreign direct investment (FDI) destination in 2010, according to Ernst and
Young’s 2010 European Attractiveness Survey. However, it is ranked the 2\textsuperscript{nd} most attractive destination following China in the next three years.

Moreover, according to the Asian Investment Intentions survey released by the Asia Pacific Foundation in Canada, more and more Canadian firms are now focusing on India as an investment destination. From 8 per cent in 2005, the percentage of Canadian companies showing interest in India has gone up to 13.4 per cent in 2010.

India attracted FDI equity inflows of US$ 1,274 million in February 2011. The cumulative amount of FDI equity inflows from April 2000 to February 2011 stood at US$ 128.642 billion, according to the data released by the Department of Industrial Policy and Promotion (DIPP).

The services sector comprising financial and non-financial services attracted 21 per cent of the total FDI equity inflow into India, with FDI worth US$ 3,274 million during April-February 2010-11, while telecommunications including radio paging, cellular mobile and basic telephone services attracted second largest amount of FDI worth US$ 1,410 million during the same period. Housing and Real Estate industry was the third highest sector attracting FDI
worth US$ 1,109 million followed by power sector which garnered US$ 1,237 million during April-December 2010-11. The Automobile sector received FDI worth US$ 1,320 million.

During April-February 2010-11, Mauritius has led investors into India with US$ 6,637 million worth of FDI comprising 42 per cent of the total FDI equity inflows into the country. The FDI equity inflows from Mauritius is followed by Singapore at US$ 1,641 million and the US with US$ 1,120 million, according to data released by DIPP.

The Government has approved 14 FDI proposal amounting to US$ 288.05 million, based on the recommendations of Foreign investment Promotion Board (FIPB) in its meeting held on March 11, 2001. These include:

- Kolkata based Dhunseri Investments got approval for FDI worth US$ 159.62 million.
- Mauritius based Ghir Investments got the approval of the Board for induction of foreign equity in an investing company. The company had proposed to get FDI worth US$ 118.36 million.
- Unihom India Pvt. Ltd. got approval for issue and allotment of partly paid up Rights Equity shares to carry out the business of
technical and engineering consultants, advisors, planners, engineering for construction of roads, airports and bridges.

- PCRD Services Pvt. Limited, Singapore, got approval to increase the foreign equity percentage in an investing company,

- G+J International Magazines GmbH, Germany, got clearance for induction of foreign equity to carry out the business of publication and sale of speciality and life style magazines in India.

- Kyuden International Corporation, Japan got approval for setting up a joint venture (JV) company that will make downstream investments in the business of developing and establishing renewable power projects.

- The total merger and acquisitions (M and A) and private equity (PE) (including qualified institutional placement (QIP)) deals in the month of February 2011 were valued at US$ 8.27 billion (76 Deals) as compared to US$ 1.95 billion (84 Deals) in the corresponding month of 2010, according to the monthly deals data released by Grant Thornton India.

**External Commercial Borrowings (ECBs)**

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million, which was marginally lower than U.S.$ 7,571 million recorded in 1996-97. ECB approvals in 1997-98 have been placed at U.S.$ 8,712 million which is slightly higher than the level in 1996-97. Regarding sectoral allocation, power accounted for the highest approvals of U.S.$ 3 billion, followed by telecom with U.S.$ 1.5 billion. In 1998-99 up to 23.12.98, approvals have been placed at U.S.$3,804 million. The reduced attractiveness of ECB of the corporate sector has been underscored by a very steep decline in actual disbursements to U.S.$ 1.6 billion in the first two quarters of 1998-99 compared to U.S.$ 4.3 billion in the same period last year. Increase in cost of ECB funds has come about due to a general increase in the risk premium for emerging market borrowers, downgrades by international credit rating agencies and the rise in forward premia. After several years of unchanged or slightly improving ratings, major rating agencies started to re-examine our ratings in early 1997. Both the deteriorating external environment and persistent large fiscal deficits have been cited as the main reasons for downgrading.

ECB is approved by the Government within an annual ceiling that is consistent with prudent debt management, keeping in view the balance of payments position. The existing ECB policy was reviewed in 1998-99 in light of the financial needs of various sectors and the impact on international markets of both the East Asian crisis
and economic sanctions. Regarding the sectoral requirements, infrastructure and exports continue to be accorded high priority in ECB allocation.

**Non Resident Deposits**

The Resurgent India Bond (RIB) scheme, launched in the current financial year, was upon to both NRIs/OCBs and the banks acting in fiduciary capacity on behalf of them. The scheme, that opened on August 5, 1998 and closed on August 24, 1998, mobilized U.S.$ 4.2 billion. The interest rates on these five year bonds were 7.75 per cent for U.S. dollar, 8 per cent for Pound Sterling, and 6.25 per cent for Deutsche Mark. Other features of RIBs include joint holding with Indian residents, allowing them to be gifted to Indian residents, easy transferability, loanability, premature encashment facility, and tax benefits. Net inflows under non-resident deposits declined from U.S.$ 3,314 million in 1996-97 to U.S.$ 1,119 million in 1997-98. The outflow under FCNRA continued due to redemption payment. Also, the relative rates of return and the perceived risk premium on emerging market debt has influenced the flows into these accounts. Some of the domestic policy-related factors which seem to have contributed towards subdued net flows include imposition of incremental cash reserve ratio of 10 per cent on non-resident deposits and the linking of interest rates under FCNR(B) with LIBOR, which had the effect of lowering interest rates offered
under this scheme, and thereby reducing its attractiveness. In order to encourage mobilization of long-term deposits, and concomitantly to discourage short-term deposits, the interest rate ceiling on FCNR(B) deposits of one year and above was raised and the ceiling on such deposits below one year was reduced in April 1998. As at the end of March 1998, outstanding balances under various non-resident deposits schemes stood at U.S.$ 20,367 million. Comparison of estimated net flows under non-resident deposits during April-November 1998 vis-à-vis the corresponding period in 1997 shows a compositional shift in favour or Rupee denominated accounts in response to policy initiative undertaken in 1997-98. Net inflows under non-residents deposits (excluding redemption payments under FCNRA which had since been discontinued) at US$ 367 million during April-November, 1998 were substantially lower than those of US$ 2266 million in the same period of 1997. Positive flows have been recorded only in the NR(E)RA and NR(NR)RD schemes. The initiatives in terms of freeing of interest rates and removal of incremental CRR, may have acted as incentives to attract deposits in these accounts.

Lass (1993), Coase (1987) in their work about the growing importance of FDI throughout the world, argued that with certain transaction cost the firm’s internal procedures are better suited than the market to organise transaction. Mundell (1957) has also
concluded on the same line that foreign direct investment should ultimately flow into those countries that are importing goods from abroad. Because of market imperfection; such as tariffs and quotas, foreign forms will find it attractive to produce locally in order to satisfy domestic demand.

The economists like Rosenstein Rodan (1961), and Chenery and Strout (1966) in the early 1960s show that foreign capital inflows have a favourable effect on economic efficiency and growth. Chenery and Strout (1966) have also stated that external finances could enhance growth prospects of recipient countries by augmenting domestic availability of investable surpluses. In the above framework, external financial inflows are presumed to result in a virtuous circle of growth. This stands out in sharp contrast to an earlier study by Haavelmo (1965), who observed that domestic savings in recipient countries could be negative, if capital inflows became large enough, implying thereby that external finance did not necessarily supplement, but might actually replace domestic savings.

Experts like Schmitz and Helmberger (1970) as well as Dunning and Norman (1983) (quoted in Stephen et al., 1993) contend that foreign direct investment creates vertically integrated production units and therefore increases the amount of trade. Numerous factors have compelled many developing economies to
change their earlier versions of trade, industrialisation and foreign
direct investment. This has been because, FDI inflows do not have
many of the costs previously associated with it and that many
developing countries have managed to industrialise successfully with
FDI. The most appropriate examples are of East Asian Economic or
newly industrialized economies (NIEs).

A number of studies show the central role played by
technology diffusion in the process of economic growth Nelson and
Phelps, 1966; Grossman and Helpman, 1991 and Barro and Sala-
I-Martin, 1955. Endogenous growth models look at FDI as an
important vehicle for the transfer of technology and knowledge
(Balasubramanyam et al., 1996) and show that FDI can have long-
run effects on growth by generating increasing returns in production
via externalities and productivity spillovers. Aitken, Hansen and
Harrison (1997) show the spillover effect of FDI on exports with the
example of Bangladesh, where the entry of a single Korean
multinational in garment exports led to the establishment of a
number of domestic export firms, creating the country’s largest
export industry. Moreover, FDI can contribute more to growth than
domestic investment when there is sufficient absorptive capacity
available in the host country (Borensztein et al., 1998). This is
because FDI flows today are not confined to the primary sectors of
developing countries but to modern manufacturing.
To make their operations more productive and efficient, transnationals take with them high levels of technology. In 1913 the primary sector accounted for more than half of FDI flows to developing countries and the manufacturing sector only 10 per cent, in 1990 about 40 per cent of FDI went to manufacturing, 50 per cent to services and only 10 per cent to primary sector (Dutt, 1997; Bahaduri, 1996). Thus FDI can lead to higher growth by incorporating new inputs and techniques (Feenstra and Markusen, 1994). Thus FDI can lead to higher growth by incorporating new inputs and techniques (Feenstra and Markusen, 1994), Kathuria (1998) finds that technology spillovers from FDI in Indian manufacturing have significant benefits. Wei (1996) uses urban data to show that FDI produces technological spillovers in China and explains growth differentials among Chinese urban areas. There are good theoretical reasons to show that the growth consequences of FDI depend on what kinds of sectors receive FDI and that the change in sectoral flows strengthen the positive effects and weaken the negative ones (Dutt, 1997).

FDI is also an important source of human capital augmentation and provides specific productivity increasing labour training and skill acquisition through knowledge transfers. De Mello and Sinclair (1995) show that FDI can promote knowledge transfers even without significant capital accumulation as in the case of
licensing and start-up arrangements, management contracts and joint ventures in general.

The idea of trade-related international knowledge spillovers developed by Grossman and Helpman (1992) is extended by Walz (1997) to FDI to show that FDI is accompanied by interregional spillovers of knowledge from the more to less advanced countries. Policies leading to an inflow of FDI therefore speed up the growth process and anything from investment controls for TNCs to specific taxes on their repatriation of profits hurts the international growth process and thereby the consumers in the developing country. Thus, theoretically speaking, the main avenues by which FDI can affect growth are productivity spillovers, human capita augmentation and technological change, though it becomes very difficult to incorporate these in empirical studies as these are not easy to measure.

The dependency theorists believe that FDI can have a favourable short-term effect on growth. In the long-run, however, as FDI accumulates, it can have negative effect on the rest of the economy due to the intervening mechanisms of dependency, in particular, “decapitalization and “disarticulation” (lack of linkages; see Stoneman, 1975; Bornschier, 1980).
Doukas and Travelos (1988) found positive abnormal returns as a result of foreign acquisition in countries in which the firms were not operating before. Goldberg and Klein (1998) identified a clear relation between real exchange rates and FDI from Japan and the United States into Southeast Asian Countries (Indonesia, Malaysia, the Philippines and Thailand). Crutchley, Guo and Hansen and Chen, Hu and Shieh examined the effect of joint venture announcements on stock price with reference to investment in Japan and China respectively. Both studies showed positive abnormal returns about (1 per cent in the case of Japan and 52 per cent in the case of China) as a result of announcements. However, in an examination of 136 foreign investment announcements during the period (1971-86) around the world, Pradhan, Wort and Strickland (1991) found significant excess negative returns for firms making such decisions. The study by Pradhan and Wort examined the wealth effect for shareholders by classifying foreign investments by geographical boundaries into Asian markets and rest of the world. The results of their study indicate insignificant positive abnormal returns for investments in Asian market, while indicating significant negative abnormal return for rest of the world.

Research by Brainard (1997) and Ekholin (1998) shows that greater distance from producing countries actually encourages domestic market-oriented investment, since the cost of exporting is
more than cost of producing there. However, Hymer (1970), Kindelberger (1970), Vernon (1966) and Caves (1971) argue that oligopolistic structure of markets, international integration, imports and the level of foreign direct investment are complementary. In a world of perfect markets transnational corporations (TNCs) would not have existed and all activities would have been carried out through free trade (Kindleberger, 1969). Knicker Backer (1973) found that FDI prosper in oligopolistic type market condition. FDI by one firm in an oligopolistic environment might trigger similar activities by other firms. Showing the importance of export-oriented FDI, Sach and Warner (1995) indicated that export-oriented FDI links the local economy to the international economy. Openness to both imports and exports has been shown to be powerful force for growth and growth has so far been the only credible means of alleviating absolute poverty.

Bajpai and Sachs (1997) in their study concluded that in the current global scenario, it is possible for India to achieve very dynamic growth based upon labour-intensive manufacturing that combines the vast supply of Indian labour including skilled managerial and engineering labour, with foreign capital technology and markets. However, from the long-term development point of view, we are of the view that India has tremendous growth prospects through export-led growth and that export-led growth involves a
broad range of sectors, both traditional and new (Bajpai and Sachs, 1998). The most interesting by far of the new sectors is software and information technology.

A comprehensive study by Bosworth and Collins (1999) provides evidence on the effect of capital inflows on domestic investment for 58 developing countries during 1978-95. The sample covers nearly all of Latin America and Asia, as well as many countries in Africa. The authors distinguish among three types of inflows: FDI, Portfolio investment, and other financial flows (Primarily bank loans).

Bosworth and Collins find that an increase of a dollar in capital inflows is associated with an increase in domestic investment of about 50 cents. They conclude that the benefits of financial inflows (FDI) were sufficient to offset the evident risks of allowing markets to freely allocate capital across the border of developing countries. Borensztein, De Gregorio, and Lee (1998) find that FDI increases economic growth when the level of education in the host country—a measure of its absorptive capacity is high.

Mello (1999) considered that FDI affects growth through the accumulation of capital as well as by the transfer of knowledge. These hypotheses were tested with time series and panel data. The
time series results were not conclusive. The panel data showed that FDI has a positive effect upon growth as a result of the transfer of knowledge in OECD countries, but not in the rest. The effect upon the accumulation of capital was only manifested in the non-OECD countries. This indicates that the end result depends on the complementarity or substitution of foreign and domestic investment.

Agarwal (2000) analysed economic impact of FDI in South Asian Countries: India, Pakistan, Bangladesh, Sri Lanka and Nepal and found that FDI inflows in South Asia were associated with a manifold increase in the investment by national investors, suggesting that there exist complementarity and linkage effects between foreign and national investment. The impact of FDI inflows on growth rate of GDP is found to be negative prior to 1980, mildly positive for early eighties and strongly positive over the late eighties and early nineties. Hence, FDI is more likely to be beneficial in the more open economies.

Bailliu (2000) analysed the impact of private capital flows, financial development and economic growth in 40 developing countries during 1975-95 and found that capital inflows faster higher economic growth, above and beyond any effects n the investment rate, but only for economies where the banking sector has reached a certain level of development.
The several results obtained by Lipsey (2000) allows us to infer that the effect of FDI on growth is positive, but reduced, and depends strongly on the interaction with the level of schooling in the host country. Soto (2000), working with panel data for developing countries for the 1986-97 period, concluded that FDI contributes positively to growth through the accumulation of capital and the transfer of technology.

Global Development Finance (2001) report summarizes the findings of several other studies on the relationships between private capital flows and growth, and also provides new evidence on these relationships. Both economic theory and recent empirical evidence suggest that FDI has a beneficial impact on developing host countries.

Wang (2001) examined the impact of FDI inflows on 12 Asian economies: Bangladesh, China, Hong Kong, India, Indonesia, Korea, Malaysia, Pakistan, Philippines, Singapore, Thailand and Taiwan during the period 1987-97 and found that FDI in manufacturing sector has a significant and positive impact on economic growth in the host economies.

A causality test between FDI and product growth was proposed by Nair-Reichert and Weinhold (2001), based on panel
data for 24 developing countries between the years of 1971 and 1985. The main conclusion here was that the relation between investments, whether foreign or domestic, and product growth was strongly heterogeneous, and that FDI efficiency was positively influenced by a country’s degree of trade openness.

Buckley and others (2002) used panel data for several regions in China for the 1989-98 period. In the first place, the author points out that if the rate of growth of FDI has positive effect upon GDP growth, the reverse does not hold true. Secondly, no evidence was found to support the hypothesis according to which the efficiency of FDI depends on a minimum level of human capital. Contrastingly, human capital is more significant in less developed provinces, while FDI stimulates growth notably in the more developed provinces.

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 $\frac{2}{3}$rd of FDI flows flow into a diverse range of manufacturing industries.”

**Pradhan Jaya 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 has 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 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 thesis that the rates of growth of GDP and FDI are related.
The study of Nawal Kisor (2003) 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, capital is more significant in less developed provinces, while FDI stimulates growth notably in the more developed provinces.

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A very recent 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.
It is clear from the above discussion that the FDI flows can induce economic activity and growth in various ways. However, Singer (1950) argues that FDI has a detrimental effect on developing countries and leads to uneven global development. This is based on the premise that FDI going to developing countries is mainly in the primary sector. However, Singer (1975) modifies his views by focusing on differences between countries rather than commodities. Griffing (1970) and Weisskopf (1972) also support the view that FDI from developed to developing countries does not have beneficial effects.

The empirical studies of Karikari (1992) and Saltz (1992) also do not find support for a positive relationship between FDI and economic growth. Karikari (1992) tests for causality using data for Ghana and finds that FDI does not affect output. In a cross-sectional study of developed and less developed countries, Saltz (1992) finds a negative correlation between FDI and economic growth.

Despite the evidence presented in recent studies, other work indicates that developing countries should be cautious about taking too uncritical an attitude towards the benefits of FDI. Hausmemn and Fernandez-Arias (2000) point to reasons why a high share of FDI in total capital inflows may be a sign of host country’s weakness rather than its strength.
In the 1970s, an important contribution was the doctoral thesis of Hymer (1976), where he came out with the industrial organization explanations of DI, and argued that the capital-arbitrage hypothesis of international capital movement was inconsistent with the obvious motives and patterns of multinational companies’ investment. As per Hymer, the organizations investing abroad should possess certain ownership advantages, or firm specific advantages, to compete with the domestic firms of another country. This study open new ways of looking at FDI and the determinants of FDI. Later Caves (1982, 1996) made significant contributions to this school of thought.

The 1970s also witnessed other developments in explaining FDI. For instance, Buckley and Casson (1976), proposed the application of internalization theory to explain the FDI based on the theory of transaction costs. Later on, in a comprehensive framework Dunning (1993a, 1993b, 1998) has synthesized the explanations of the past researchers to suggest three conditions for FDI: O-wnership advantages, L-ocation advantages, popularly known as OLI.

The significance of this OLI framework was explored by most of the studies on inward FDI in the 1980s and evening the late 1990s. Given the nature of FDI and the fact that the main source of FDI is the developed countries in the world, the existence of ownership advantages is a foregone conclusion. That shifts the entire
focus on the location advantages and related determinants, for the inflows of FDI. The locational advantages for FDI arise due to the existence of certain pull factors in the recipient countries, like large and growing markets, low wage rates, export orientation, a fair degree of regionalization of markets, political stability, economic and fiscal policies conducive to foreign investment, liberalized and market driven economies, state-of-the-art infrastructure, etc. The studies based on such indicators and employing multivariate techniques sought to establish the statistically significant determinants of inward FDI.

Based on a review of the past studies, we summarize below selected findings on significant determinants of inward FDI.

Host country markets as a determinant has two facets, market size and market growth rate. In spite of the strong theoretical base for the importance of these variables, empirical results have been observed to vary. Clegg (1995) (quoted in Castro (2000) found in his study with data for 40 years (1951-90) that when the data for the entire period was taken, market size and growth rate, were in significant. Later, when he split the data into two periods 1951-72 and 1973-90, market size was significant in the earlier period and the growth rate in the later period. So, he concluded that new investment sought a big market and subsequent investment sought growing
market. This may be said to be in accord with a priori reasoning. Subsequent studies (Hill and Munday, 1992 and Lucas, 1993), for instance confirm that market size is a significant determinant of FDI. More recently Chen Chunlai (1997) also found the market size is a significant determinant of FDI, in his study of 33 developing countries.

Causality can also run from the state of the economy to FDI because economic activity itself may be determinant of FDI. This would be the case if higher economic activity or growth leads to a larger market size that can increase the attractiveness of a country for multinationals. The market size may enable investors to exploit potential economies of scale. Further, foreign investors may be attracted to a country where technology is changing fast since technological progress can provide opportunities to increase profits.

Holland and others (2000) reviewed several studies for Eastern and Central Europe, producing evidence of the importance of market size and growth potential as determinants of FDI. Tsai (1994) analysed the decades of 1970 and 1980 and addressed the endogeneity problem between FDI and growth by developing a system of simultaneous equations. Also, FDI was alternatively measured as a flow, and as a stock. Market size turned out to be more important for FDI flows than growth. The trade surplus
presents a negative sign and is significant for FDI, while the flow of FDI decreases as the nominal wage decreases. On the other hand, the impact of FDI on economic growth is quite limited.

**Campos and Kinoshita (2003)** use panel data to analyse 25 transition economies between 1990 and 1998. They reached the conclusion that for said set of countries FDI is influenced by economy clusters, market size, the low cost of labour, and abundant natural resources. Besides all these factors, the following variables presented significant results: sound institutions, trade openness, and lower restrictions to FDI inflows.

Internalisation theory introduced the determinant Physical and Cultural Proximity in the studies of FDI. The physical distance is expected to increase the cost of intra-firm coordination and factor input transfers, for example. Cultural distance may inhibit FDI. Veugelers (1991) (quoted in Castro (2000)) concluded that shared language and neighbourhood increase FDI. The study of Moore (1993) also supported the neighbourhood phenomenon.

Political risk has always been ranked high among the determinants of FDI by most of the studies. Lucas (1993) suggested events that generate political instability do reduce the flow of FDI, but they have a short-run impact. The studies of Achinivu (1990) and
Soon (1990), concluded that political stability was a significant determinant of FDI. The difficulty in studying this variable is that political risk generally is a matter of perception of the country where the FDI originates. A friendly host country government may still attract FDI into the country in spite of political risk. Also, the firms seeking a portfolio balancing effect of their investment across the world, may be willing to invest in high risk country.

Some economists have studied the effect of variables (determinants) that determine the flow of FDI. Caves (1982) concluded that the shortcomings in the availability of intangible assets such as knowledge, technology, managerial and marketing skills may lead to the formation of MNCs. Whereas Culem (1988) reports a positive impact of population upon foreign investment within developed countries. Economists like Lucas (1990), considers Political risk as one of the major reasons why capital doesn’t flow from wealthy to poor nations as freely as predicted by neo-classical theorists. Aharoni (1966, 1973) in his studies reinforced that although managers attempt to avoid risk in their investment decisions, many dimensions of risk are difficult to measure. Thus, the political risk associated with FDI has a high subjective content.

Considering Exchange Rate volatility and BOP position is extremely important, when the stake of fixed capital in the
investment is high (Dunning, 1993a). Goldberg and Kolstad (1995) provided a model to explain the impact of exchange rate volatility on the location of MNEs. Achinivu (1993) found the access to foreign exchange to be a significant variable along with the ease in repatriation. Lucas (1993) found a positive association between FDI and the level of foreign exchange reserves, although the causation here can be from FDI to reserves as well. Grosse and Trevino (1996) (quoted in Castro (2000)) suggested that exchange rates were one of the most significant factors in explaining FDI in US. However, Moore (1993) found evidence that German investors favour countries with fixed exchange rates with Deutsche mark.

Infrastructure is an obvious requirement for any investment, more so with FDI. Loree and Guisinger (1995) studying the determinants of foreign direct investment by United States in 1977 and 1982 (both towards developed countries as well as toward developing countries), concluded that variables related to host country policy were significant in developed countries only when infrastructure was an important determinant in all regions. Munteanu (1991), in his studies found that multinational corporation desires to operate within a developed nation, possessing a reliable infrastructure because that will result in more efficient distribution system. Wheeler and Mody (1992) too have shown “Well developed infrastructure” as a determinant of capital investment by
multinationals. The shifts in the determinants of FDI as observed by the UNCTAD World Investment Report 1998 confirm that created assets in the form of infrastructure can definitely influence the inflow of FDI. Macro-economic factors, legal framework and structural reforms are among the important determinants of FDI. A very recent paper authored by Venkateswarlu and Kameshwar Rao (2004) brings into focus the determinants of FDI. The level of per capital GDP and growth rate of GDP were found as the determinants of FDI. Fundamental economic factors, e.g., inflation rate, are of not much value for obtaining FDI. They are useful for portfolio investment.

Garibaldi and others (2001), based on a dynamic panel of 26 transition economies between 1990 and 1999, analysed a large set of variables that were divided into macro-economic initial conditions, and risk analyse. The results indicated that macro-economic variables, such as market size, fiscal deficit, inflation and exchange regime, risk analysis, economic reforms, trade openness, availability of natural resources, barriers to investment and bureaucracy all had the expected signs and were significant.

Review

Following the analysis of Donald-MacDougall and Paul Streetan (1960), Gerald Meier (1996) observes in their analysis that, from the stand point of national economic benefit, the essence
of the case for encouraging an inflow of capital is that the increase in real income resulting from the act of investment is greater than the resultant increase in the income of the investor. If the value added to output by the foreign capital is greater than the amount appropriated by the investor, social returns exceed private returns. As long as foreign investment raises productivity, and this increase is not wholly appropriated by the investor, the greater product must be shared with others, and there must be some direct benefits to other income groups such as domestic labour, consumers, government, and external economies.

In fact, the effects of FDI on the host country can be classified into economic, political and social effects. The basic presumption that is found in the literature, which is based on the principles of neoclassical economies, is that FDI raises income and social welfare in the host country unless the optimum conditions are significantly distorted by protection, monopoly and externalizes (Lalls and Streetten, 1977).

The economic effects of FDI can also be classified into macro-effects and micro-effects. The usual convention in analyzing the macro-effects of FDI is to treat it as a rise in foreign borrowing if there is unemployment and capital shortage (as it is typically the case in developing countries). Such borrowing leads to a rise in output
and income in the host country. FDI will, under these conditions, have a beneficial effect on the balance of payments but an indeterminate effect on the terms of trade (depending on whether the impact of increased output falls on import substitutes or exports).

The micro-effects of FDI pertain to structural changes in the economic and industrial organization. For example, an important issue is whether FDI is conducive to the creation of a more competitive environment or conversely to a worsening of the monopolistic and/or oligopolistic elements in the host economy. In general, the micro-effects pertain to individual firms and individual industries, particularly those that are closely exposed to and associated with FDI.

Borenstein and other (1995) tested the effects of FDI on economic growth in across-country regression framework, utilizing data on FDI flows from industrial countries to 96 developing countries over two decades. Their results suggest the following conclusions:

i) FDI is an important vehicle for the transfer of technology, contributing relatively more to growth than domestic investment.

ii) For FDI to produce higher productivity than domestic investment, the host country must have a minimum threshold stock of human capital.
iii) FDI has the effect of increasing total investment in the economy more than proportionately, which suggests the predominance of complementary effects with domestic firms.

There is a relationship between investment and employment. In the General Theory, Keynes (1936) suggested the existence of a direct relationship between investment and employment. However, there is still considerable divergence in views among economists about the employment effect of FDI. Baldwin (1995) argues that this debate encompasses three key issues: (i) the extent to which FDI substitutes for domestic investment, (ii) the extent to which FDI stimulates increase of exports of intermediate goods and capital goods and, (iii) whether FDI involves the construction of new plants or simply the acquisition of existing facilities. In general, the employment effects of FDI may be summarized as follows:

i) FDI is capable of increasing employment directly, by setting up new facilities or indirectly by stimulating employment in distribution.

ii) FDI can preserve employment by acquiring and restructuring ailing firms.

iii) FDI can reduce employment through divestment and the closure of production facilities.
The balance of payments effect is more important for developing countries than for developed countries. This is because foreign exchange is regarded as scarce resource affecting growth through the foreign exchange gap. Hence, any effect of FDI may mitigate or worsen the constraints imposed by the balance of payments on the attainment of macro-economic objectives pertaining to growth and employment. In general, FDI is often blamed for its balance of payments effect: the investing country faces a sudden deficit when the FDI occurs, whereas the host country faces a small perpetual deficit as a result of profit repatriation. After all, a profitable FDI project with profits repatriated in foreign currency must necessarily result in greater, balance of payments outflows that a similar project financed locally.

Productivity is likely to rise and unit cost is likely to decline if (i) FDI is export promoting and the products of the subsidiary are destined for the large world markets, and (ii) the underlying conditions and policies allow the installation of plants designed to achieve the full economies of scale. On the other hand, if FDI is import substituting and the size of the market is too small to allow the installation of the optimum plant size, then productive efficiency may not be achieved. There are, however, some reasons for believing that productive inefficiency may not be important. First, the empirical evidence indicates that unit costs of operating a plant
smaller than the optimum size are not significantly higher than those of the most efficient scale. Secondly, even if investment was mainly import substituting, any scope for some exports leads to an increase in the size of the market and allows the utilization of a higher capital intensity technology.

According to Industry Minister (ex) Mr. Murasoli Maran, “foreign investment is not considered only as a stock of capital but as something that provides modern technology, modern management practices, employment opportunities and a new market for products produced in India. Moreover, it is essential. We have a gap between our savings and investment rates. The gap can only be filled by FDI.” MNCs offer the capital, international market access, and technology that India lacks, and are therefore vital to remolding India as a strong and rapidly growing economy. The FDI has proved to be resilient during financial crises. For instance, in East Asian Countries, such investment was remarkably stable during the global financial crises of 1997-98. In sharp contrast, other forms of private capital flows—portfolio equity and debt flows, and particularly short-term flows—were subject to large reversals during the same period (Lipsey, 2001). This resilience of FDI during financial crises was also evident during the Mexican crises of 1994-95.
In nutshell important advantages of FDI may include the following:

1. It helps increase the investment level and thereby the income and employment in the host country.
2. FDI facilities transfer of technology to the recipient country.
3. It may kindle managerial revolution in the recipient country through professional management and the employment of highly sophisticated management techniques.
4. Foreign capital may enable the country to increase its exports and reduce import requirements.
5. Foreign investments may stimulate domestic enterprises because to support their own operations, the foreign investors may encourage and assist domestic suppliers and consuming industries.
6. Foreign investment may also help increase competition and break domestic monopolies.

The role of FDI in the export performance of host country industries has received considerable attention in recent years, especially in the context of liberalisation and globalisation. A cross-country analysis of 52 countries by the UNCTAD (1999) found that there is a positive relationship between FDI and manufactured exports, and the relationship is stronger for developing countries than for developed countries and in high and low-tech industries than in medium-tech ones. Aitken et al. (1997) conducted a study on
Mexican manufacturing firms for the period 1986-90 and found that export decision of Mexican firms is positively related to the presence of foreign firms; which is measured using two separate variables – MNEs’ production and their exports. They found that the presence of MNEs with their production and export activities positively influence the export performance of Mexican firms. Kokko et al (2001) examined the association between FDI spillovers and the export behaviour of domestic firms in Uruguay using a cross-sectional firm level data. They found that domestic firms are more likely to export if they operate in sectors where the presence of foreign firms is relatively high. Their study also pointed out that the type of trade regime (controlled or liberalized) may influence the ability of MNEs in generating positive export spillovers.

Sjoholm (1999) examined the various types of foreign contacts that influenced as well as enabled the establishments to become exporters in the Indonesian manufacturing sector. Taking three types of foreign contacts – foreign ownership, imports, and spillovers from regional presence of FDI – the study found that while the first two types of foreign contacts (ownership and imports) have a positive effect on the propensity to become an exporter, there are no export spillovers from a large regional presence of FDI. Greenaway et al (2004), using a two-step Heckman selection model to determine the influence of FDI spillovers on the export decision of
domestic firms, found positive FDI spillovers on the export decision of domestic firms, found positive FDI spillovers on the probability of a United Kingdom firm being an exporter. They found that the most important channel of export spillovers is the increased competition resulting from foreign firms.

A number of studies have attempted to analyse the impact of FDI on the export performance of Indian industries. In India, earlier studies for the period of restrictive policy regimes could not find any significant difference in the export performance of foreign and domestic firms (Kumar and Siddharthan, 1994). However, a number of studies for the post-1991 liberalisation period suggest that foreign firms have shown significantly higher export performance as compared to domestic firms (Aggarwal, 2002; Kumar and Pradhan, 2003) compared the export performance of MNE affiliates and domestic firms in Indian manufacturing after the 1991 liberalisation by analyzing the determinants of their export intensities. The study examined the relationship between FDI and export performance using the Tobit model for 916 Indian manufacturing firms for the period 1996-2000. Aggarwal found that the liberalisation measures of the 1990s enhanced the export role of MNE affiliates, especially in the late 1990s. However, she could not find any evidence of a positive relationship between foreign equity share and export performance of firms.
Kumar and Pradhan (2003) looked at the important factors that influence the export competitiveness of Indian manufacturing firms with an emphasis on knowledge-based industries. They found that younger firms drive export competitiveness in the high and low technology industries whereas older firms are more competitive in the medium technology industries. The study also found that foreign affiliates are better achievers on the export front compared to their domestic counterparts in Indian manufacturing. The study concluded that the liberalisation policies of the 1990s have definitely improved the export competitiveness of Indian manufacturing, especially in the technology-intensive segments. Banga (2003) also found a significant impact of FDI on the export intensity of non-traditional export industries in India.

Most of these studies examined the role of foreign equity participation in the export decision of firms in Indian manufacturing and merely compared the export performance of domestic and foreign firms without looking into the possibilities of export spillovers from foreign firms. This study attempts to analyse the effect of FDI spillovers on the export performance of Indian firms in a liberalized framework.

Having presented a review of literature of earlier studies on Foreign Direct Investment, the next chapter presents the theoretical background of economics of Foreign Direct Investment.