Chapter I

INTRODUCTION

Foreign Direct Investment is a component of a country’s national financial accounts. Foreign direct investment is the investment of foreign assets into domestic structures, equipment, and organizations. It does not include foreign investment into the stock markets. Foreign direct investment is thought to be more useful to a country than investments in the equity of its companies because equity investments are potentially “hot money” which can leave at the first sign of trouble, whereas FDI is durable and generally useful. FDI motivate economic growth for every stage of development of a country. Developing countries experience both strong capital accumulation and technology transfer through FDI.

Now-a-days well accepted that both economic growth and development are highly dependent on improving not just the availability of capital, but also access to technological capabilities, infrastructure and resources. This has gone hand-in-hand with an increasing economic liberalization of most developing countries. The role of the MNE as a viable source of both capital and technology is one of the key features of this new openness. Foreign direct investment is that investment, which is made to serve the business interests of the investor in a company, which is in a different nation distinct from the investor’s country of origin. A parent business
enterprise and its foreign affiliate are the two sides of the FDI relationship.

Foreign direct investment (FDI) in India has played an important role in the development of the Indian economy. FDI in India has – in a lot of ways – enabled India to achieve a certain degree of financial stability, growth and development. This money has allowed India to focus on the areas that may have needed economic attention, and address the various problems that continue to challenge the country. India has continually sought to attract FDI from the world’s major investors. In 1998 and 1999, the Indian national government announced a number of reforms designed to encourage FDI and present a favourable scenario for investors.

Statement of the problem

Foreign direct investment, which is inward, is a typical form of what is termed as ‘inward investment’. Here, investment of foreign capital occurs in local resources. The factors propelling the growth of inward FDI comprises tax breaks, relaxation of existent regulations, loans on low rates of interest and specific grants. The idea behind this is that, the long run gains from such a funding far outweighs the disadvantage of the income loss incurred in the short run. Flow of inward FDI may face restrictions from factors like restraint on ownership and disparity in the performance standard. Foreign direct investment, which is outward, is also referred to as “direct investment abroad”. In this case it is the local capital, which is being invested in some foreign resource. Outward FDI may also
find use in the import and export dealings with a foreign country. Outward FDI flourishes under government backed insurance at risk coverage.

Foreign direct investment may be classified by their set target. The areas here are Greenfield investment and Acquisitions and Mergers. Greenfield investments involve the flow of FDI for either building up of new production capacities in the host nation or for expansion of the existent production facilities of the host country. The plus points of this come in form of increased employment opportunities, relatively high wages, R&D activities and capacity enhancement.

The flip side comes in the form of declining market share for the domestic firm and repatriation of profits made to a foreign country, which if retained within the country of origin could have led to considerable capital accumulation for the nation. Multinationals mostly rely on mergers to bring in FDI. Until 1997 mergers and acquisitions does not render any long run advantage to the economy of the host nation as under Greenfield investments. Consistent economic growth, de-regulation, liberal investment rules, and operational flexibility are all the factors that help increase the inflow of Foreign Direct Investment.

FDIs can be broadly classified into two types: outward FDIs and inward FDIs. This classification is based on the types of restrictions imposed, and the various prerequisites required for these
investments. An outward-bound FDI is backed by the government against all types of associated risks. This form of FDI is subject to tax incentives as well as disincentives of various forms. Risk coverage provided to the domestic industries and subsidies granted to the local firms stand in the way of outward FDIs, which are also known as ‘direct investments abroad.’ Different economic factors encourage inward FDIs. These include interest loans, tax breaks, grants, subsidies, and the removal of restrictions and limitations. Factors detrimental to the growth of FDIs include necessities of differential performance and limitations related with ownership patterns.

Though the services sector in India constitutes the largest share in the Gross Domestic Product, still it has failed to some extent in attracting more funds in the forms of investments.

**Foreign direct investments in India are approved through two routes**

**1. Automatic approval by RBI**

The reserve Bank of India accords automatic approval within a period of two weeks to all proposals and permits foreign equity up to 24%; 50%; 51%; 74% and 100% depending on the category of industries and the sectoral caps applicable. The lists are comprehensive and cover most industries of interest to foreign companies. Investments in high-priority industries or for trading
companies primarily engaged in exporting are given almost automatic approval by the RBI.

2. The FIPB Route – Processing of non-automatic approval cases

FIPB stands for Foreign Investment Promotion Board which approves all other cases where the parameters of automatic approval are not met. Normal processing time is 4 to 6 weeks. Its approach is liberal for all sectors and all types of proposals, and rejections are few. It is not necessary for foreign investors to have a local partner, even when the foreign investor wishes to hold less than the entire equity of the company. The portion of the equity not proposed to be held by the foreign investor can be offered to the public.

The spillovers from foreign direct investment through multinational enterprises have attracted considerable attention in recent times. Existing empirical studies on FDI spillovers largely look at the productivity enhancing effects and horizontal spillovers of foreign firms in the same industry sector ignoring the possibility of spillovers through buyer-supplier or backward linkages. Increased competition in the domestic market post-liberalisation through sales of foreign firms is forcing domestic firms to look for export markets. The domestic firms are not benefited in improving their export performance through any buyer-supplier linkages with the MNEs.
The extent of globalisation of a country’s economy is usually evaluated from its trade and investment relations with the rest of the world, especially the volume and growth of trade from that country. Exports help firms to achieve greater efficiency in production through economies of scale due to increased market size. Studies point out that exports may also improve the innovative activities of the firm, with new varieties of products and new methods of delivery to be competitive in quality and to stay in the business. For an exporter to be successful in a foreign market requires good knowledge about the foreign market conditions such as foreigners; preferences, regulations, distribution channels and other market characteristics. However, collecting information on some of the above-mentioned variables may usually be costly and this may deter entry of firms into the foreign market. There can be substantial reduction in sunk entry cost with various types of foreign contacts since such contacts may provide knowledge on foreign conditions. There are different channels through which foreign contacts can take place, the most important is through the foreign direct investment (FDI) by multinational enterprises (MNEs).

MNEs typically have a presence in many markets, making them a potential source of information about foreign markets, consumers and technology. Therefore, higher foreign equity participation by MNEs may lead to higher export performance. This
impact on exports of domestic firms is through direct contact with the multinationals. Sometimes, the presence of MNEs in the domestic market itself would increase the export performance of domestic firms. The information with the MNEs on foreign markets may leak out to the domestic firms even if they do not participate in joint ventures with foreign firms. This externality is one type of “spillovers” from FDI. Spillovers can also take place when the presence of MNEs improves the productive efficiencies of domestic firms, making their products competitive in price and quality in the international market, thus improving their export performance. These types of spillovers are known as “horizontal spillovers” since they occur to domestic firms in the same industry group of foreign firms through competition. Similarly, the multinational buyers of intermediate goods may provide information about other possible international purchasers of those products, so that the domestic intermediate goods producers can expand their production and achieve the economies of scale that will in fact reduce the price of their products. This aspect of spillover from foreign firms arising through buyer-supplier linkages are mostly known as “backward spillovers”.

The literature classifies FDI based on MNE’s market strategy into domestic market-seeking and export-oriented. Most of the developing countries (China, Malaysia, Indonesia, Thailand, etc.) are
now mostly looking at export-oriented FDI to strengthen their export competitiveness. Export-oriented FDI can be expected to generate strong links with the local economy compared to local market-oriented FDI in the host country specifically because it is motivated to exploit the location advantages offered by the host country such as low-cost labour, raw materials, components and parts, among others. The presence of export-oriented FDI and the interaction with them may induce the domestic firms to diversity into export market when information on foreign markets brought in by foreign firms spill over to them. While local market-oriented FDI may crowd out domestic firms and investments, export-oriented FDI can stimulate investment by generating demands for intermediate goods. The experience of China and Mexico shows that these countries were able to increase their international market shares mostly by attracting export-oriented FDI (UNCTAD 2002). Therefore, it is expected that spillover effects will be large from the presence of export-oriented MNEs compared to domestic market-seeking ones.

However, such type of growth-led, efficiency seeking and export-oriented FDI can be materialized only if the regulatory regime facilitates greater freedom to the MNEs in their operations. The protected markets are more likely to attract tariff-jumping FDI which are, therefore, likely to be more domestic market-seeking. Economic liberalisation through opening up of the economy will
force the tariff-jumping, market-seeking type of MNEs to restructure their strategies due to increased competition from imports, new foreign firms and diligent indigenous firms. The existing MNE-affiliates would have to look at technology upgradation either through technology imports or through research and development (R & D) activities to strengthen their competitiveness. The MNEs would also have to look at external markets to maintain their growth and profitability. Therefore, economic liberalisation would not only attract more efficiency-seeking, export-oriented FDI but also force of existing MNEs to reframe their strategies. The presence of foreign firms with their sales, international marketing exposure and expertise are expected to increase the competitiveness and export orientation of domestically owned firms in developing countries through either “horizontal spillovers” or “backward spillovers”.

**INDIAN INVESTMENT TREATY PROGRAMME IN THE LIGHT OF GLOBAL EXPERIENCES**

An exponential growth in bilateral investment treaties, accompanied by an increasing number of investor-state investment disputes has given rise to two global issues. One, the relationship between the number of such treaties and investment inflows, and two, concerns over the compromise of regulatory discretion due to obligations imposed. In the Indian context the most important regulatory framework on foreign investment.
There is no comprehensive multilateral treaty framework to regulate global investment flows. Instead, there exists a scattered and fragmented regulatory regime to regulate global investment flows in the form of bilateral investment treaties (BITS). BITS – often perceived as admission tickets to investments – are agreements signed between two countries under which each country binds itself to offer treaty-based protection to investments and investors of the other country. This treaty-based protection includes the condition of not expropriating or nationalizing foreign investment unless or until there is a public purpose and is accompanied by due compensation; not discriminating between foreign and domestic investment and between foreign investments from different counties; treating investors and investments in a fair and equitable manner; allowing free repatriation of profits and other investment-related funds. Above all, it includes a provision on investor-state dispute settlement system with the power to enforce arbitral awards. Under this, an individual foreign investor can directly bring a case at an international arbitral tribunal without the consent of the state and in many cases without exhausting the local remedies in the host country, if it is of the view that the host country has violated the BIT. In the last two decades, there has been an exponential growth of BITS – from about 500 in 1990 to more than 2,500 by the end of 2008 (UNCTAD 2009). This exponential growth in BITS has also been accompanied by an increasing number of investor-state
investment disputes – from a mere 14 disputes reported in 1987-98 to 317 till the end of 2008.

This exponential growth in the number of BITS and disputes has given rise to two important issues. The first issue relates to whether there is a direct co-relationship between a country signing BITS and investment inflows in the light of the fact that many countries are entering into BITS to presumably attract investment. The second issue is related to the concerns expressed over the compromise of regulatory discretion of host countries due to the obligations imposed by BITS as evident from the disputes involving the scrutiny of impact of regulatory discretion on investments. The purpose of this note is to look at the gigantic Indian investment treaty (BIT) programme in light of these two important global issues. However, before these two issues are discussed, it will be pertinent to offer a couple of disclaimers followed by a brief outline of the Indian BIT programme. The two disclaimers are as follows – first, this note looks at the Indian BITS from the perspective of India being a host nation and not from the perspective of India being a capital exporting country; and second, the limited space available makes it impossible to discuss all the issues raised in the note, in great detail.
Important sectors of the Indian Economy attracting more investments into the country are as follows:

- Electrical Equipments (including Computer Software and Electronic)
- Telecommunications (radio paging, cellular mobile, basic telephone service)
- Transportation industry
- Services Sector (financial and non-financial)
- Fuels (Power + Oil Refinery)
- Chemical (other than fertilizers)
- Food Processing Industries
- Drugs and Pharmaceuticals
- Cement and Gypsum products

The arrival of new and existing models, easy availability of finance at relatively low rate of interest are key catalysts of growth in the globalised economy, particularly for emerging market economies. The role of Foreign Direct Investment in the present world is noteworthy. It acts as the lifeblood in the growth of the developing nations. Flow of the FDI to the countries of the world truly reflects their respective potentiality in the global scenario. Flow of FDI truly reflects the country’s both economic and political scenario.

A larger Foreign Direct Investment Inflows require for the development of multi various activities in different sectors like agriculture, health, education, energy, national highways, industries,
infrastructure and employment generation. The FDI inflows play a peculiar role in the development of the economy. In a globalised economy the FDI inflows is must for the development of the economy. The present study brings about an economic analysis of the Foreign Direct Investment inflows into India.

**Objectives of the study**

The following are the objectives of the present study.

- To analyse the trends of FDI inflow into India from 1991-92 to 2009-2010.
- To analyse the FDI openness of Select Asian Countries.
- To analyse the sectors attracting highest FDI inflows into India.
- To analyse the Foreign Technology Transfer.
- To analyse the share of top investing countries FDI inflow.

**Hypotheses**

The following are the hypotheses of the study

- FDI inflows into India since 1991 shows an increasing trend.
- FDI openness of select Asian countries show the positive trends.
- Foreign Technology Transfers shows the Green signal to the growth and development of the Economy.

**Methodology**

The present study completely relies upon the secondary data published by the Reserve Bank of India (RBI), United Nations Conference for Trade and Development (UNCTAD), Secretariat for
Industrial Assistance (SIA), Centre for Monitoring Indian Economy (CMIE), Central Statistical Organisation (CSO) and Economic Survey of Government of India. The secondary data relating to various dimensions of FDI such as inflow of FDI into India, FDI openness of Select Asian countries, the sectors attracting highest FDI inflows into India etc. have all been collected for economic analysis.

Such statistical tools like, percentage, simple growth rates, mean average, frequency tables, correlation have been used in the study. For data illustration suitable diagrams and trend lines have also been used. The collected data have been classified, tabulated and analysed.

**Limitations**

There are certain limitations in the present study namely,

1. Lack of continuous time series data in the RBI Bulletin and other sources of publication, so some tables have been framed only with available data.
2. Since the non-availability of some data for some years under the study period more number of statistical applications could not be given.
3. Ph.D. theses on FDI is very rare in our Universities; Hence the more review from theses could not be given.

**Period of the study**

The present study covers the period of 19 years from 1991-92 to 2009-2010. In addition to it, monthly FDI inflows and revised FDI inflows have also been analysed for the year 2010-2011.
CONCEPTS

Foreign Direct Investment

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

Private Debt Flows

Private Debt Flows composed of bonds, bank loans and other credits issued or acquired by private enterprise without any public guarantee. Official Development Finance (ODF) consists of development assistance and other flows.

Portfolio Investment

Portfolio investment is guided by the speculative gain and involves in acquiring financial assets such as equities, bonds and debentures. As a matter of fact what has become highly mobile across the world is not productive capital, but financial capital, especially in the form of hot money.

Equity Capital

Equity Capital refers to the foreign investors’ purchase of shares of an enterprise in a country other than its own.
Re-invested Earnings

Re-invested Earning comprise the direct investors’ share of earnings not distributed dividends by affiliates or earning not remitted to the direct investors. Such retained profits of affiliates are invested.

Vertical Mergers

Vertical Mergers implies merger of firm involved in different stages of the production of a single final report.

Horizontal Mergers

Horizontal Mergers implies the merger of two or more firm engaged in similar activities in the same industry.

Conglomerate Mergers

Conglomerate mergers involves merger of firms engaged in unrelated activities.

Horizontal FDI

Horizontal FDI is undertaken to produce the similar goods abroad as in the home country.

Vertical FDI

Vertical FDI is undertaken for either to exploit raw materials (backward vertical FDI) or to be nearer to the customers through the acquisition of distribution outlets (forward vertical FDI).
Conglomerate FDI

Conglomerate FDI involves both horizontal and vertical FDI.

Import-Substituting FDI

Import-substituting FDI involves production of goods previously imported by the host country. This type of FDI is determined by the market size of the host country.

Export-increasing FDI

Export-increasing FDI is motivated by the desire to seek new sources of input. It helps to increase the export of the host country.

Government-initiated FDI

Government-initiated FDI is a type attracted by the incentive offered by the government in an attempt to eliminate balance of payment crisis.

Forms of Investments

Foreign Direct Investment (FDI) is permitted as under the following forms of investments

- Through financial collaborations.
- Through joint ventures and technical collaborations.
- Through capital markets via Euro issues.
- Through private placements or preferential allotments.
Forbidden Territories

FDI is not permitted in the following industrial sectors:

- Arms and ammunition.
- Atomic Energy.
- Railway Transport.
- Coal and lignite.
- Mining of iron, manganese, chrome, gypsum, sulphur, gold, diamonds, copper, zinc.

Foreign Investment through GDRs (Euro Issues)

Indian companies are allowed to raise equity capital in the international market through the issue of Global Depository Receipt (GDRs). GDR investments are treated as FDI and are designated in dollars and are not subject to any ceilings on investment. An applicant company seeking Government’s approval in this regard should have consistent track record for good performance for a minimum period of 3 years. This condition would be relaxed for infrastructure projects such as power generation, telecommunication, petroleum exploration and refining, ports, airports and roads.

Clearance from FIPB

There is no restriction on the number of Euro-issue to be floated by a company or a group of companies in the financial year. A company engaged in the manufacture of items covered under
Annex-III of the New Industrial Policy whose direct foreign investment after a proposed Euro issue is likely to exceed 51% or which is implementing a project not contained in Annex-III, would need to obtain prior FIPB clearance before seeking final approval from Ministry of Finance.

**Use of GDRs**

The proceeds of the GDRs can be used for financing capital goods imports, capital expenditure including domestic purchase/installation of plant, equipment and building and investment in software development, prepayment or scheduled repayment of earlier external borrowings, and equity investment in JV/WOSs in India.

**Chapterisation**

Chapter I is introductory, presenting the statement of the problem, objectives, hypotheses, methodology and chapter scheme.

Chapter II presents the review of literature of the earlier studies.

Chapter III presents the theoretical background on Economics of Foreign Direct Investment.

Chapter IV presents the theories and policy of FDI in India.

Chapter V deals with the data analysis relating to Foreign Direct Investment Inflows into India.

Chapter VI continuation of the data analysis.

Chapter VII Findings, suggestions and conclusions.