**Introductory Background and Theoretical Approach of the Study**

### 1.1 Introduction:

Most of the present day developing countries of the world have set out a planned programme for accelerating the pace of their economic development. In any country planning for industrialization and aiming to accomplish a target rate of growth there is need for resources. The resources can be mobilized through domestic as well as foreign sources. As far as the domestic sources are concerned, they may not be sufficient to acquire a certain rate of growth. Generally domestic saving is less than the required amount of investment. Besides the very process of industrialization calls for import of capital goods which cannot be locally produced. So, there comes the need for foreign resources. They not only supplement the domestic saving but also provide the host country\(^1\) with extra foreign exchange to import essentials for economic development. Thus foreign resources are craved for filling the saving investment gap and foreign exchange gap. They are available to developing countries in mainly three types.

1. Export of goods and services
2. External aid
3. Foreign investment

Export of goods and services contribute to foreign exchange but they can meet only a small fraction of the total demand for foreign resources.

External aid from foreign governments and international institution by increasing the rate of home savings and removing the foreign exchange gap permits the utilization of previously underutilized resources and capacity. But generally aid is tied and distorts the allocation of resources. Therefore its use has been on the decline.

The third type of foreign resources is foreign investment which is of two types.

1. Foreign Portfolio Investment (FPI)
2. Foreign Direct Investment (FDI)

Foreign Portfolio Investment involves (a) purchase of existing bonds and stocks with the sole objective of obtaining dividends or capital gains and (b) investment in new

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\(^1\) Host country refers to a country that receives an inflow of FDI while Home country refers to a country that generates an outflow of FDI.
issues of international bonds and debentures by the financial institution or foreign government.

The FDI is an investment that involves a long term relationship and control by a resident entity of one country, in a firm located in a country other than that of the investing firm. FDI is assumed to take place when an investor has acquired 10% or more of the voting power of a firm located in a foreign economy (IMF, 2004).

1.2 Foreign Direct Investment:

There is no specific definition of FDI owing to the presence of many authorities like OECD, IBRD, IMF and UNCTAD. All these bodies try to illustrate the nature of FDI with certain measuring methodologies. Generally speaking FDI refers to capital flows from abroad that invest in the production capacity of the economy and are usually preferred over other forms of external finance because they are non-debt creating, non-volatile and their returns depends on the performance of the projects financed by the investors. FDI also facilitates international trade and transfer of knowledge, skills and technology. It is also described as a source of economic development, modernisation and employment generation, whereby the over all benefits triggers technology spillovers, assists in human capital formation, contributes to international integration and particularly exports, helps to create a more competitive business environment, enhances enterprise development, increases total factor productivity and improves efficiency of resource use. Hence, FDI means the transfer of financial capital, technology and other skills like managerial, marketing and accounting expertise and practices. This relates costs and benefits for the countries involved both the home country and the host country.

Considerable attempts have been made to assess as to what costs are borne and what benefits are enjoyed by the two countries. There is even fundamental disagreement on what constitutes the costs and benefits of FDI from the perspectives of the two countries. This disagreement is indicated by the big gap between those holding free market views and those with anti-globalization. Sharing of the welfare gains between the host country and the home country depends not only on given market scenario but also on the relative strength of the two countries in bargaining over the terms and conditions governing a particular FDI project. It is not necessarily an optimal market condition that one country’s gain must be accompanied with other country’s loss. For
an effective FDI both countries must believe that the expected benefits to them must be greater than the costs. Such trusts are the essence of an agreement to be reached to initiate the underlying project.

1.3 Benefits of Foreign Direct Investment:

One of the advantages of FDI is that it helps in the economic development of the particular country where the investment is being made. This is especially applicable for the economically developing countries. During the decade of the 1990s FDI was one of the major external sources of financing for most of the countries that were growing from an economic perspective. It has also been observed that FDI has helped several nations when they have faced economic hardships.

An instance of this could be seen in some countries of the East Asian region. It was observed that during the global financial crises of 1997-98 (in East Asian countries) the amount of FDI made in these countries was pretty steady, though the other forms of cash inflows like debt flows and portfolio equity had suffered major setbacks. Similar observations have been made in Latin America in the 1980s and in Mexico in 1994-95.

FDI also permits the transfer of technologies. This is done basically in the way of provision of capital inputs. The importance of this factor lies in the fact that this transfer of technologies cannot be accomplished by way of trading of goods and services as well as investment of financial resources. It also assists in the promotion of the competition within the local input market of a country. It can also bring in advanced technology and skill set in a country. There is also some scope for new research activities being undertaken.

Inflow of FDI also helps in the development of human capital resources through training on the operations of a particular business. The profits that are then generated can be used for the purpose of making contributions to the revenues of corporate taxes of the recipient country.

Besides all this the other major advantages of FDI are that it helps in the creation of new jobs in a particular country, thereby increasing the salaries of the workers. This enables them to get access to a better lifestyle and more facilities in life.

FDI assists in increasing the income that is generated through revenues realized by taxation, due to the development of the manufacturing sector of the recipient country.
It also plays an essential role in the context of rise in the productivity of the host countries. Their companies get an opportunity to explore newer markets through exports that allows them to cash in on their superior technological resources, and thereby generate more income and profits. It has also been observed that as a result of receiving FDI, the recipient countries can keep their rates of interest at a lower level, thus enabling the business entities to borrow finance at lesser rates of interest. The biggest beneficiaries of these facilities are the small and medium-sized business enterprises.

However, little evidence is available on the impact of FDI on the rural economy and on the poverty. But FDI inflows are associated with higher economic growth, which is critically important for poverty reduction. Besides FDI indirectly benefits poor by creating better employment and earning opportunities for unskilled labour in the developing countries like India.

### 1.4 Costs of Foreign Direct Investment:

Recent years have seen increased public concern that the benefits of FDI have yet to be demonstrated and that, where it exists, they may not be shared equitably in the society. The cost of FDI occurs mostly in case of matters related to operation, distribution of the profits made on the investment and the personnel.

The situations in countries like Ireland, Singapore, Chile and China corroborate such an opinion. It is normally the responsibility of the host country to limit the extent of impact that may be made by the FDI. They should be making sure that the entities that are making the FDI in their country adhere to the environmental, governance and social regulations that have been laid down in the country. The various cost of FDI is understood the most in matters of strategic importance like national security and defence.

It has been observed that certain foreign policies are adopted that are not appreciated by the workers of the recipient country. FDI is also disadvantageous for the ones who are making the investment themselves. FDI may entail high travel and communications expenses. The differences of language and culture that exist between the country of the investor and the host country could also pose problems in case of FDI. Besides that there is considerable instability in a particular geographical region. This causes a lot of problem to the investor.
Another, major disadvantage of FDI is that there is a chance that a company may lose out on its ownership to an overseas company. This has often caused many companies to approach FDI with a certain amount of caution.

The size of the market, as well as, the condition of the host country also influences the FDI. In case the host country does not have good bilateral relations with their more advanced neighbours, it poses a lot of challenge for the investors. The government of the host country also faces problems over the control of those companies that are functioning as the wholly owned subsidiary of an overseas company. This leads to serious issues since investor is not completely obedient to the economic policies of the country where they have invested the money. At times there have been adverse effects of FDI on the balance of payments (BOPs) of a country. As more foreign investors invest in the country, the demand for domestic currency rises. Consequently the value of domestic currency appreciates. Appreciation of domestic currency causes loss of competitiveness of exports as they become costlier. Cheaper imports and costly exports further add to current account deficit in BOP.

1.5 Economic, Political and Social Effects of Foreign Direct Investment:

The controversy of expectation and realization would not have taken place if the host country had achieved what the classical economist suggested with relation to the effects of FDI. They pioneered the positive theories of FDI that stipulates that FDI flows are in consequences of mobility of capital towards profit maximization. Since in most cases the host countries lack capital which is essential factor of production, such inflows are desirable from the point of global efficiency. It is further complemented by the surplus and cheap labour that most of these host countries often enjoy, which serves the condition of cost minimization vis-a-vis profit maximization. This is the argument of classical economists that suffers from over simplification. Market is not perfect in nature. The varieties of imperfections are so much that the MNFs (Multinational Firms) are able to exploit the host country without their knowledge and forcing the host country to adopt protectionist approach. Such worries sometime lead to over protectionism. This is a departure from the classical proposition and quite often utilised by the multinationals to be even more aggressive. They take their protection as well by means of further manipulation of market imperfections in the form of transfer pricing, shadow pricing, dumping, monopolistic competitions. At the
end, there are welfare losses on the part of host countries in the form of departure from efficiency optimality and constant return to scale. Quite often the multinationals are encompassed world-wide and have accumulated so much wealth that it become a real threat to the stability of the host country. These are often categorized as the economic effects of FDI. There are political effects as well which are not really isolated from the economic effects. Sovereignty of host countries can be at stake in case of taking very protective policies. Instances are there that political government had been over thrown while taking nationalization policies of FDIs. The modern system of FDI contributing to different political parties of the host countries does have political implications as well. These are the political parties having the potentials of making governments in future. The social issues are mainly concerned with the creation of enclaves and foreign elite in the host country as well as the cultural effects on the local population i.e. custom and tastes. Naturally social issues are more likely to arise when there are significant economic, social and cultural differences between the home and host countries.

The economic effects of FDI can be classified into macro 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. Under these conditions FDI will have a beneficial effect on balance of payments but an uncertain effect on the terms of trade (depending on whether the impact of increased output falls on imports substitutes or exports). The micro effects of FDI concerns structural changes in the economic and industrial organization. For example an important issue is whether FDI is contributive to the creation of a non competitive environment or conversely to a worsening of the monopolistic or oligopolistic elements in the host country. In general the micro effects concern individual firms and individual industries. Particularly those that are closely associated and exposed to FDI.

Like the theories of FDI there is significant over lapping in the discussion of these effects. Like, the provision of capital as performed by FDI overlaps significantly with the effect on the balance of payments and the effect on output. Moreover technology is believed to be the main channel through which FDI affects growth and productivity.
During the past few decades the activities of MNFs have grown at a phenomenal rate. The MNFs perform their business activities which can be broadly classified as direct investment including FDI, technology transfer, Mergers and Acquisitions, Collaborations, Joint Ventures 100% subsidiaries and marketing of financial services. However, their main instrumentality of business is primarily through FDI. The significance of FDI in the world economy is much less controversial than its influence on economic growth, although an overwhelming majority of country’s economic now explicitly regard FDI as an integral and crucial part of their growth strategy. Since India’s economic liberalization in the 1990’s the role of FDI in the growth and development of the developing countries is ever greater and significant. The origin of World Trade Organization (WTO) in January 1995 has further given boost these economies to go in a long way for more FDI in a varieties of arrangement such as joint ventures, technological collaboration etc.

1.6 Foreign Direct Investment and Economic Development:

It has been observed that the economically developing as well as underdeveloped countries is dependent on the economically developed countries for financial assistance that would help them to achieve some amount of economical stability. The economically developed countries, on their part, can assist these countries financially by investing in these countries. This financial assistance can be channelized into various sectors of the economy. The channelization is normally done on the basis of the requirements of particular sectors. FDI has a major role to play in the economic development of the host country. Over the years, FDI has helped the economies of the host countries to obtain a launching pad from where they can make further improvements. This trend has manifested itself in the last seventeen years. Any form of FDI pumps in a lot of capital resources and technological knowledge into the economy of a country. This helps in taking the particular host economy ahead. The fact that the foreign direct investors have been able to play a significant role vis-a-vis the economic development of the recipient countries has been due to the fact that these countries have changed their economic stances and have allowed the foreign direct investors to come in and improve their economies.
It has been observed that the FDI has been able to improve the infrastructural condition of a country. Besides that the private sector companies are not always interested in undertaking activities that help in improving the infrastructure of the country. This is because the gains from these infrastructural activities are made only in the long term; there are no short term benefits as such. So as infrastructural sector is one of the most crucial and capital intensive sector but due to insufficiency of domestic capital FDI play an important role. It can also assist in helping economically underdeveloped countries build their own research and development bases that can contribute to the technological development of the country. This is a very crucial contribution as most of these countries are not able to perform these functions on their own. These assistances come in handy, especially in the context of the manufacturing and services sector of the particular country, that are able to increase their productivity and ultimately advance from an economic point of view. The health sector of many a recipient country has been benefited by the FDI through availability of financial and technological and marketing skills.

Besides infusion of capital FDI could also be provided in the form of technology. This is an indirect way in which FDI plays an important part in the context of economic development. Another important contribution of FDI is in the field of educational sector. It can help in assisting the host countries to set up mass educational programs that help them to educate the disadvantaged sections of the society. Such assistance is often provided by the non-governmental organizations in the form of subsidies. The standard of living of the general public of the host country could be improved as a result of the FDI made in a country. Thus it may be said that it plays an important role in the overall economic and social development of a country.

1.7 Effects of Foreign Direct Investment: Theories and Approaches:

The significance of FDI is being recognized globally since it has accelerated remarkably in the last decades and many of the major corporations of most developed countries have taken their production of goods and services to many diverse parts of the world. Investments are more often to take place where locational and comparative advantages are present and FDI is usually concentrated in the regions where the industry in question will perform most efficiently. In order to compete in foreign
markets, multinational MNCs (Multinational Corporations) take advantage of their firm-specific resources, such as technological and marketing skill (Blomström & Kokko, 1997)

There are several reasons for a firm to undertake FDI. It can be market-seeking (horizontal) or resource-seeking (vertical) FDI. Market-seeking FDI takes place when a MNC invests because of domestic market size, prospects for market growth, transportation costs and the need to be close to potential customers. Resource-seeking FDI seeks comparative advantages such as access to raw material, cheap input and low cost of labour.

To analyze the determinants and effects of FDI a large number of studies have been conducted till now. In a landmark study, Agarwal (1980) examined the different aspects pertaining to FDI theories under perfect market conditions. The study used different variables such as differential rate of return, the portfolio diversification and the market size. He also examined the theories under imperfect market conditions. Similar kind of discussion has also been organized in other alternative ways. For example Boddewyn (1985) grouped the theories according to conditions and participating circumstances for FDI. Kojima and Ozawa (1984) differentiated between micro and macro model of FDI. The following theories pertaining to FDI have been critically appreciated.

1.7.1 Theories of Foreign Direct Investment under Perfect Market Condition:

1. Differential Rate of Return
2. Portfolio Diversification Theory
3. Output and Market Size Approach

According to the differential rate of return approach, FDI is the result of capital flowing from the countries having higher returns. The evaluation of investment decisions is done by comparing the marginal return with the marginal cost of capital. If the marginal return is higher in other countries than at home and assuming that the marginal cost of capital is the same for both types of investment then the investment decision will be in favour of other countries rather than home country. In the late 1950’s this theory gained popularity when the FDI in manufacturing sector from USA increased sharply in Europe. At that time after tax rate of returns of US subsidiaries in manufacturing were above the rate of return on US domestic manufacturing.
However, this relationship did not last long. During the 1960’s US FDI in Europe continued to rise even when the rate of return were high in domestic manufacturing (Hufbaur, 1975). These hypotheses have been tested in many ways. Some authors even tried to find a positive relationship between the ratios of firm’s FDI to its domestic investment and the ratio of its foreign profits to its domestic profits. Others tried to relate FDI and the rate of foreign profits usually after allowing for a certain time lag. Another approach was to examine the relationship between relative rates of return in several countries and the allocation of FDI in these countries (Lizondo, 1991).

Agarwal (1980) argued on the validity of these empirical studies as it did not provide strong supportive evidence mainly due to difficulties in measuring anticipated profits. In most cases reported profits were used to represent anticipated profits. However reported profit may differ from the anticipated profits. Besides it does not explain some aspects of FDI. Since this theory argues that capital flows from countries with low rate of return to countries with high rates of return which is assumed implicitly that there is a single rate of return with in a country. Thus the theory failed to explain why there are some countries experiencing simultaneous inflows and outflows of FDIs. Thus the theory of differential rates of return failed to explain the determinants of FDI flows.

The theory of portfolio diversification provides a useful foundation for explaining the nature and causes of FDI flows. It emphasized that the role of risk in choosing among the various available projects should also be taken into consideration. FDI across countries takes place due to the goals of risk diversification. Hence FDI decisions are guided by assessment of anticipated returns and risk diversification. This follows the theory of portfolio diversification of not putting all the eggs in the same basket. It has been seen empirically that some of the highly profitable MNCs concentrates in few regions rather than going for wider diversification. This contradicts the theory of diversification. The theory however is an improvement over the differential rates of return theory because of the inclusion of risk factor. Of course an individual investor can reduce risk even by means of making his own portfolio diversified rather than the firm itself goes for diversification. The other point that remains unexplained by this theory is that it does not explain about the concentration of FDI in some industries than in others.
The ‘output approach’ takes into consideration the variable of output (sales), while the market size approach considers the host country’s Gross Domestic Product or Gross National Product as the proxy for sales potential. The relevance of output for FDI can be derived from the neo-classical model of domestic investment theory whereas the relevance of host country’s market size has generally been postulated rather than derived from a theoretical model. Despite the lack of explicit empirical backing the market size model has been very popular and a variable representing the size of the host country appears in a large number of empirical studies.

1.7.2 Theories of Foreign Direct Investment under Imperfect Market Condition:

Theories under imperfect market condition are reviewed as follows:

1. Industrial organization.
2. Internalization theory.
3. Product cycle theory.
4. Eclectic or OLI theory.
5. Oligopolistic Reaction Theory.

Hymer (1976) was the first researcher who pointed out that the structure of market and the specific characteristics of firm play an important role in explaining the FDI. He advocated that the existence of MNFs depends on market imperfections. There are two important types of market imperfections namely structural imperfections and transaction cost imperfections. Structural imperfections help the MNF in increasing its market strength through economies of scale, advantages of knowledge, distribution network, product diversification and credit advantages. While the transaction cost imperfection makes profit for the MNFs to substitute on internal market for external transactions. The study of structural imperfections led to the industrial organization theory of FDI whereas the study of transaction cost gave rise to the internalization theory of FDI (Graham & Krugman, 1989). The Industrial organization theory argues that a MNF faces a number of disadvantages in case of competition with domestic firms. These difficulties include the problems of managing operations, dealing with different cultures, legal system, languages, customer preferences, technological standards etc. Despite these disadvantage a MNF enjoy some firm specific advantages.
with respect to domestic firms. The merits of MNF are their brand name, patent, protected superior technology, marketing managerial skills, cheaper sources of financing, preferential access to market and economies of scale. However, it is observed that the industrial organization theory is not complete as it did not explain as to why the competition must take the form of FDI.

The Internalization theory (Buckeye & Casson, 1976) states that the existence of FDI as a result of firms replacing market transaction with formal transactions. This is a way of avoiding market imperfection for intermediates inputs. Modern business follows many activities in addition to the daily activities of producing goods and services. These other activities include marketing, R & D and training of labour which are related with the flow of intermediate goods mostly in the form of knowledge and expertise. However the market imperfections make it difficult to price some of the intermediate goods (Coase, 1937). The main characteristics of this theory is treating markets on the one hand and firms on the other as alternative modes of organizing production. The internalization of markets beyond national boundaries leads to the formation of MNFs which result in FDI. This process continues till the equalization of costs and benefit from internalization is complete. This is also known as general theory of FDI. Rugman (1980) opines that most of the hypotheses for FDI are the particular cases of the internalization theory. The theories of imperfect condition are attributed to three basic elements i.e. industrialization in a country, internalization in a country and presence of location factor. The central theme of this theory is that FDI would be attracted by favourable supply conditions which have their origin in those factors underlying industrialization, internalization and location. It does not call into question the demand conditions for an integrated plan of FDIs.

Vernon (1966) introduced the product cycle theory to explain the nature and causes of FDI. According to this theory direct foreign investment is a natural and climatic stage in the life cycle of a new product introduced to the market by oligopolistic firms. The product first appears as innovations and ultimately become completely standardized. Innovation can be the result of reacting with more severe competition or can be outcome of exploiting new profit opportunity. Vernon’s theory viewed “direct foreign investment as diffusive mechanism or solution to the problem of intensifying competition at both home and abroad. The perfect example illustrating the Vernon’s theory is the manufacturing of electronics.
The Eclectic theory of FDI also known as the Ownership Location and Internalization (OLI) paradigm of FDI was first propounded by Dunning (1977, 1979, and 1988) which combined three theories of FDI namely industrial organizational theory, location theory and internalization theory. According to him three conditions must be satisfied if a firm wants to be a MNF. Firstly, the firm must have some ownership advantages with respect to other firms. Secondly, it should have other advantages like sell or lease to other firms. Lastly, the firm must be more beneficial to use these advantages with some inputs located in other countries. It also postulates that advantages of this theory are not likely to be uniform since all countries, industries, enterprises and are likely to change over a period of time. However, the Eclectic theory does not consider the risks associated with the trade groupings, floating exchange rate and the super structure of global credit system (Dunning, 1979).

Knickerbocker (1973) gave the ‘Oligopolistic Reaction theory’. This theory explained that the FDI by one firm will lead to propagate the other firms to do the same in order to maintain their market share (Graham, 1978). In this perspective Hufaur (1975) contradicted that “due to increased industrial concentration, the competitors compete among themselves to achieve cost or marketing advantages over each other. But this increases in industrial concentration between different products of MNFs with their expenditure on R&D. An important implication of this theory is that the process of FDI by MNFs in self limiting due to increased concentration in home and other market the competition will increase amongst them and this will reduce the intensity of Oligopolistic reaction. A major criticism of this theory is that it does not recognize FDI as one of the several methods of foreign investment and it has also failed to give reasons for the start of foreign investment process.

Helpman and Krugman (1985) developed the ‘new trade theory of FDI in response to the failure of classical trade theories of incorporating concepts observed in actual flows of international trade such as intra-industry trade. The new trade theories contributed by constructing general equilibrium trade models which could include increasing return to scale, imperfect competition and product differentiation. The main assumption in these theories was about single plant national firms, which limited the usefulness of these models explaining FDI. But the earlier trade theory failed to incorporate together MNCs and FDI. However during the eighties and nineties, Markusen (1995) and other researchers modified the new trade models to allow for
inclusion of MNCs and FDI. An important contribution of new trade theory models incorporating MNCs is that they can be used to analyze a firm’s decision between FDI and exports. The decision between foreign production and exports revolves around the “Proximity concentration trade-off”, where MNCs compare trade costs to the costs of producing at several locations. The proximity concentration trade off” has resulted in the idea of two primary forms of FDI, i.e. horizontal and vertical.

The above discussions dealt with some important theories related to the nature and causes of FDI flows in the world. An attempt has been made here to concentrate on the nature of FDI flows in India.

1.8 **Locational Factors that Influence Foreign Direct Investment Inflows in India:**

1. **Market Size:**
Market size is one of the most important considerations in making investment locational decisions. The attractiveness of large market is related to large potential for local sales, because domestic sales are more profitable than exports especially in larger countries such as India where economies of scale can be eventually reaped. Also such countries offer more diverse resources which make local sourcing more flexible. India is one of the largest markets with a huge growing affluent middle class (300 million). According to IMF (2011) in terms of Purchasing Power Parity India ranked the third largest in the world, with a gross domestic product of US $ 4.46 trillion while in USD exchange-rate terms, it is the 10th largest in the world, with a GDP of US $ 800.8 billion. Furthermore, India is the second fastest growing major economy in the world, with a GDP growth rate of 9.2% at the end of the first quarter of 2007-2008. The higher GDP, the better is the country’s economic health and better is the prospects that the direct investment will be profitable. Hence GDP has a positive influence on direct investment from abroad.

2. **Economic Stability of the Country:**
Monetary and fiscal policies determine the parameters of economic stability such as the interest rates, tax rates and the state of external and budgetary balances which influences the investment rates, as described below:
a) **Interest rates:**

Interest rates affect the cost of capital in a host country, directly affecting one of the determinants of the investment decision. The effects of interest rates on FDI are smaller than on domestic investment because MNCs normally have a greater choice of sources of financing. It was 4.25 percent in the year 2009.

b) **Level of External Indebtedness:**

It is expected to have a negative impact on FDI inflows. The level of indebtedness shows the burden of repayment and debt servicing on the economy thus making the country less attractive for foreign investor. India’s external debt stood at US$221.2 billion in 2008 which was 18.8 percent of GDP (Economic survey 2007-08).

c) **Debt Service Ratio:**

This is represented by total debt service as a percentage of total income of the country. The higher this ratio, the higher will be the burden of the country to service the debt out of the income of the country. The FDI inflows are expected to increase with a small debt service ratio. Thus this variable is having negative correlation with FDI inflows. It was 4.4 percent in the year 2008 (Economic survey 2009-10:143).

d) **Foreign Exchange Reserves:**

The higher the level of foreign exchange reserves (FERs) in terms of import cover reflects the strength of external payments position and helps to improve the confidence of the investors. Hence a positive relationship is expected between the FERs and the inflow of FDI. It was US$254.6 billion in 2008.

e) **Exchange Rate Regime:**

Exchange rate represents the investment climate in the country. High exchange rate will erode the profitability of foreign investment, increase the cost of production and introduce distortions in the host country’s economy. Hence a negative relationship can be expected between the exchange rate and the flow of foreign capital. Exchange rate of the Indian rupees vis-a-vis the SDR, US dollar, Pound sterling and Euro were 68.6, 43.4, 80.2 and 63.7 respectively in 2008.

f) **Inflation Rate:**

A high rate of inflation is a sign of internal tension and of the inability of the government and the central bank to balance the budget and to restrict the supply of money. As a rule, the higher the inflation rate, the less will be the FDI inflows. A negative relationship is expected. Recently it is very high (9.9% in 2009).
g) Deficit in the Balance of Payment:
A large deficit in Balance of Payment indicates that the country lives beyond its means. The danger increases that free capital movement will be restricted and that it will be more difficult to transfer the profit from the direct investment into the home country. Hence a negative relationship can be expected. In the year 2008 it has US$ - 118.4.

3. Availability of Human Capital:
The continued expansion of MNCs in the past was a response of differential availability of factor endowments in different countries. Cheap and productive labour reduces the cost of production and yields high profitability. Low wage rates and higher labour productivity thus is expected to have a positive effect on FDI inflows. India has 16 percent of world population with 402 million (2001) labour force. Besides India has a large pool of trained manpower, with 700,000 science graduates and engineers qualifying annually. This includes 122000 chemists around 50,000 pharmacists, 150,000 chemistry post graduates and chemical engineers and approximately 1500 Ph.D.

4. Availability of Natural Resources:
The availability of natural resources (raw material) for manufacturing is one of the most important factors in investment decision making. If the resources are available locally the cost of production remains low, as the cost of transportation is saved. It is the sustained availability of the resources which matter in the investment decisions. Nature has bestowed upon India a number of mineral resources. Ample deposits of coal, iron, bauxite, mica, manganese, gypsum, chromate and limestone are found in Indian territory.

5. Economic Policies of the Host Country:
Economic policies includes the industrial policies, trade policies, tax structure, the intellectual property protection regime, bilateral investment treaties, regional integration frameworks, multilateral investment framework and so on of a country. Government policies are possible determinants of FDI since the government considers FDI flows as a means to fight unemployment and increase national growth rate.

6. Infrastructure Facilities:
The establishment of industry requires a highly developed infrastructure. The developments of roads, rail, electricity and communication system are important
infrastructural facilities which are essential for the development of the industry. These factors are responsible for the attraction of FDI and the lack of which becomes a hindrance.

7. Agglomeration Effects:
Agglomerations also have significant effects on attracting FDI. Agglomeration economies arise from the presence of other firms, other industries, as well as from the availability of skilled labour force. It correspond to positive spillovers form investors already producing in this area. This gives rise to economies of scale and positive externalities, including knowledge spillovers, specialized labour and intermediate inputs. Thus high FDI today implies high FDI tomorrow.

1.9 Importance of Foreign Direct Investment for Growth and Development in India:

After independence it was realized that the economy was in a bad condition and in need of massive reconstruction. There was shortage of capital, productive facilities, manpower and entrepreneurs. The infrastructure of the country inherited was not compatible for production. The technological know-how was poor. Policy makers at that time realized the importance of foreign capital and technology to furnish the needs. The political leadership of “Swadeshi” at that time was rather sceptic due to the bitter experiences of British rule. They bypassed the real need of foreign capital and technology in the forms of restrictive policies. Through these policies provided the country with a foundation of local technology in the manual form backed by low capital. That created enough employment opportunities for the poor economy of India but compared to the global development of technology the indigenous technology lacked efficiency. By 1950s the policy makers felt the importance of foreign capital and technology in the country. The first five year plan introduced to allow foreign investment at least in the agriculture sector. However during 1960s and 1970s there were a number of collaboration with Russia particularly in the power, petroleum, Coal mining, steel and Iron, drugs and pharmaceutical sectors. But the country was yet to accept the investment of capitalist countries in view of their nature of exploitation. The congress party in the 1980’s made the economy more liberalized by permitting a number of sectors including telecommunication, infrastructure, banking and information technology open for foreign investments. It was observed that the initial
experiences were not bad as the locally protected firms availed the opportunity of becoming more competitive at the global standards.

In India the lure of non-debt creating FDI flows has galvanized successive governments since 1990-91. Now the government talks about ensuring $25 billion FDI flows into India as the minimum consideration for achieving the economic growth target of 8 percent per annum. Because the sustained flow of FDI would give the economy a smooth ride to banish the twin dangers of endemic poverty and huge unemployment and cope with the vast investment requirements of maintaining the rickety infrastructure and creating more facilities.

Therefore, in the line of globalization foreign capital and technology was realized as an urgent need for the development of the economy. Consequently in 1991, the government of India introduced ‘new economic policy’ with policy of liberalization. Most of the sectors were allowed for foreign investment except very few like defence and strategic sectors. The emergence of the WTO made these a kind of obligation. The commitment of the country with the WTO and the IMF made official withdrawals of all restrictive policies in favour of investment climate of global standards. Now India is committed to provide one of the best investment opportunities of FDI i.e. ranked second position according to Global Business Policy Council (2005). Within a span of about 18 years FDI in India has increased nearly 165 times from 1991 to 2008 and attracted more than 1 billion US dollar per year. Except defence and strategic sectors all the sectors of the economy are now ready for FDI. The statistics highlight the role of FDI in the growth and development of the Indian economy.

The pharmaceutical industry of India has also observed a transition during this period. The technology of the sector observed a tremendous development and the quality of output improved remarkably. The sector now contributes 90 percent of domestic consumption and a sizeable figure to the export of India. This indicates that the intensity of production and promotion of FDI inflows in the sector have increased significantly. It may be argued that the development of pharmaceutical industry in India is an outcome of the flow of FDI in the sector.
1.10 Conclusion:

FDI play multidimensional role in the overall development of the host country. It may generate benefits through bringing non-debt creating foreign capital resources, technology upgradation, skill enhancement, new employment, spillovers and allocative efficiency effects. It plays a complementary role in overall capital formation and filling the gap between domestic saving and investment. At the macro level it is a non-debt creating sources of additional external finances. At the micro level it is expected to boost output, technology, skill level, employment and linkages with other sectors and the regions of the host economy. Thus FDI acts as a catalyst for domestic industrial development and considered to be an important vehicle for economic development. According to Chaturvedi (2011) the value of Karl Pearson correlation is found to be +0.89 means a high degree correlation between FDI and economic development. While FDI has many disadvantages also like increased market concentration, foreign interference, damages to the nations customs and culture etc. The major factors that attract FDI in India are huge market size, low cost and skilled labour, sound macroeconomic development, abundant natural resources etc.

A theoretical review on FDI has revealed that the different theories have led emphasis on varied micro and macro factors, which as a result, influence the foreign investment in an economy. It is therefore inappropriate to assess the role of FDI through the application of single theory and what is needed in the present globalizing economy of the world is to blend and combine the indigenous and exogenous factors impinging upon the decision for inviting foreign investment in an economy.

In the succeeding chapter an attempt is made to review the literature on the subject matter of FDI in different sectors of the economy with special reference to pharmaceutical industry. The study has further presented the statement of the problem, objectives, scope and scheme of chapterisation. Research design and methodology suitably carved out keeping in mind the hypotheses formulated to critically examine the role of FDI in promotion of pharmaceutical industry in India.
1.11 References: