ABHINAV
International Monthly Refereed Journal of Research In Management & Technology
ISSN – 2320-0073 Volume II, March'13

FOREIGN DIRECT INVESTMENT AND INDIAN ECONOMY SINCE 1991-2008

Sachin Agrawal[1] and Dr. Sanjivkumar Agrawal[2]

[1]Teaching Associate, New Model Degree College, Hingoli, India
Email: sachin.agrawal1985@gmail.com
[2]Associate Professor, Toshniwal College, Sengaon, India
Email: agrawalsanjiv22@gmail.com

ABSTRACT

This paper studies the evolution of FDI from being a small component of total industrial investment in India to becoming a major economy booster. It observes the changes in its composition, factors that attract it and effects of its fluctuating behaviour on the Indian exports. Regression analysis is the primary statistical tool employed to determine growth rates and relations between economic variables.

INTRODUCTION

Compared to most industrialising economies, India followed a fairly restrictive foreign private investment policy until 1991 - relying more on bilateral and multilateral loans with long maturities. Inward foreign direct investment (FDI, or foreign investment, or foreign capital hereafter) was perceived essentially as a means of acquiring industrial technology that was unavailable through licensing agreements and capital goods import. Technology imports were preferred to financial and technical collaborations. Even for technology licensing agreements, there were restrictions on the rates of royalty payment and technical fees. Development banks largely met the external financial needs for importing capital equipment. However, foreign investment was permitted in designated industries, subject to varying conditions on setting up joint ventures with domestic partners, local content clauses, export obligations, promotion of local R and D and so on - broadly similar to those followed in many rapidly industrialising Asian economies. Foreign Exchange and Regulation Act (FERA), 1974 stipulated foreign firms to have equity holding only up to 40 per cent, exemptions were at the government's discretion. Setting up of branch plants was usually disallowed; foreign subsidiaries were induced to gradually dilute their equity holding to less than 40 per cent in the domestic capital market. The law also prohibited the use of foreign brands, but promoted hybrid domestic brands (Hero-Honda, for instance). However, pragmatism prevailed to ensure stable domestic supply at reasonable prices. Such a restrictive policy is believed to have retarded domestic technical capability (as reflected in the poor quality of Indian goods); it also meant a loss of export opportunity of labour-intensive manufactures - in contrast to many successful East Asian economies. Moreover, such a policy is said to have encouraged 'rent seeking' by domestic partners on imported technology - with little efforts to improve product quality, undertake innovation, and seek export markets. This popular perception was perhaps best illustrated by the passenger car industry that produced obsolete (and fuel- inefficient) models of the 1950s at very high costs in small numbers. Without denying some of these arguments and evidence, others have shown that the regulation reduced costs of technology imports, and promoted export of goods with relatively stable technologies where domestic firms had the opportunity of 'learning by doing' by catering to the large domestic market - as illustrated by successful firms like TELCO (commercial vehicles) and BHEL (heavy electrical equipment). The recent international achievements of some Indian pharmaceutical firms (Cipla, Ranbaxy, Dr Reddy's Laboratories, for instance) is also attributed to the regulatory and promotional policies, and the patent laws that sought to encourage domestic production to reduce drug prices. However, the 1980s witnessed a gradual relaxation of the foreign investment rules - perhaps best symbolised by the setting up of Maruti, a central government joint venture small car project with Japan's Suzuki Motors in 1982. It was followed by Pepsi's entry in the second half of the decade, to primarily export processed food products from Punjab, and also to bottle its well known beverages for the domestic market.

History of FDI in India

Pre and Post Independence

Foreign Direct Investment in India dates back to the pre independence period, where it was handled predominantly by the East India Company with British companies being a major source of FDI. India was a land of abundant raw material and food materials, but there was lack of interest by the British in developing finished product industries. A majority of the investment was used to suit their own political and business interests, often to the detriment of growth of the Indian economy.

After independence, the first Prime Minister of India pointed out the importance of FDI not just as a source of capital, but for the host of technological and industrial knowledge it would bring with it. India lay out and started following a strategy of import substituting industrialization in the framework of development planning with a focus on encouraging and improving local capability, mostly in heavy industry and machine manufacturing sectors. To compensate for the general limited availability of technology, skills, entrepreneurship, bringing in FDI was one of the top priorities. However, being a nation just freed from colonial power and hence weary of major foreign intervention, the restrictions were plenty such as those on FDI unaccompanied by technology transfer, and those seeking more than 40% foreign ownership.

Changing Policies with the decades

The 1970s brought in more restrictions. FDI was only allowed in a selected group of core or high priority industries. The Foreign Exchange Regulation Act (FERA) and Monopolies and Restrictive Trade Practice (MRTP) were imposed in 1973, which required numerous permits and clearances for all foreign companies to operate in India. This discouraged the FDI flows considerably. The MRTP discouraged the growth of domestic large industries by imposing a world of restrictions and prevented economies of scale from realizing. Thus industrial growth was throttled for both domestic and foreign industries. Exceptions were made only for companies in the high technology sectors, plantation and export driven companies.

The mid-1980s brought about a positive change as the industries began to get modernized with liberalized imports of capital goods and technology. The benefits of these changes were plenty with a set of MRTP licensing rules that had been liberalized, a host of incentives now being provided, increased degree of flexibility concerning foreign ownership and an overall introduction of the Indian market to foreign competition, which was going to prove only too valuable. India also allowed qualified NRI investors to invest in India through equity participation. Also, the industry had become more export driven. The bulk of FDI inflows during this time were directed to the manufacturing sector, hence it accounted for the bulk of the FDI stock with nearly 87% share in 1980, that went down to 85% by the time 1990 arrived.

Economic Crisis and Liberalization of Economy

By the time the 1990s came however, much more serious problems had crept up. India's foreign exchange reserves had reached an all time low, with only enough resources to last for about three weeks. The exports scenario was in troubled waters. The overall balance of payments figure had reached (-) 44710 million. Inflation was at its highest level of 13%. The political instability of the country did not do much to help either. In such a scenario, Finance Minister Manmohan Singh, with the help of the IMF and the World Bank, launched on a long term plan of macro-economic stabilization. India opened its doors to FDI by doing away with the restrictive policies surrounding it and making them more liberal, thus ending the License Raj. The New Industrial Policy (NIP) announced in 1991 led to abolition of industry licensing system except in only a few select cases. Foreign ownership up to 100% was now allowed in most manufacturing sectors, except defence equipment (26%) and items reserved for production by small scale industries (24%).

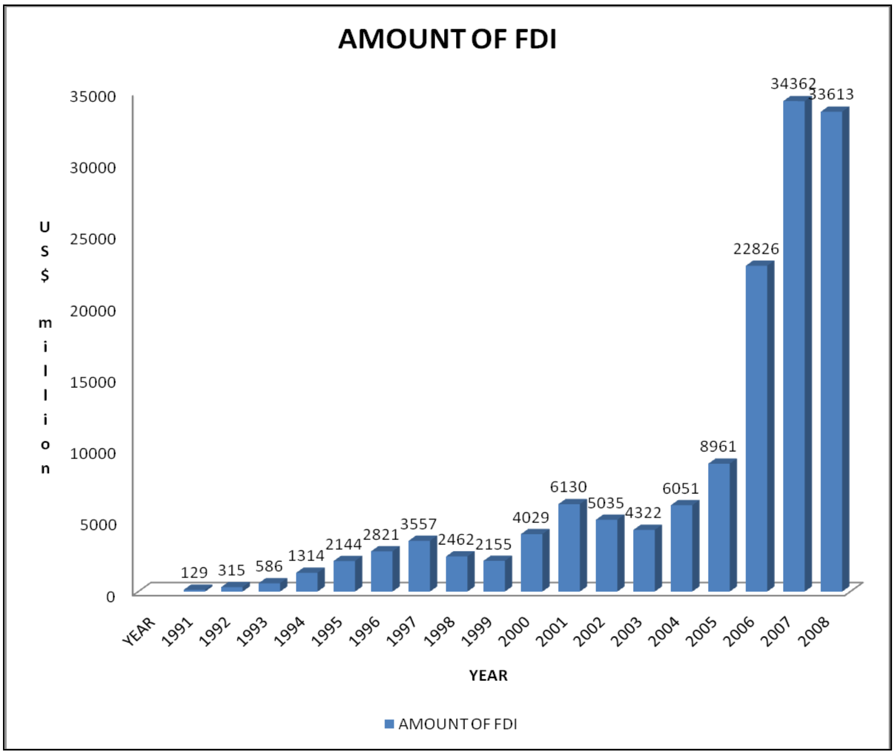
Effects of Liberalization on sectors

The liberal policy allowed non-manufacturing sectors to come into the limelight for the first time, with the share of 'others' sector, that includes infrastructure and power management, stepping up by nearly 35% in total FDI from marginal in the 1980s The service sector which included activities like banking, hotels, tourism, railways, insurance, business services showed marked improvement with telecommunications benefiting the most (61%), and financial and banking sector (14%) coming in second.

India's recently liberalized FDI policy (2005) allows for a 100% FDI stake in ventures. Owing to the plethora of skilled managerial and technical expertise available in India, the service sector has been among the biggest gainers. Sectors like power generation, mining, and banking are some of the newer sectors reaping rewards from the liberalized FDI norms.

Table 1. Amount of FDI Inflows (1991-2008)

Year	**Amt. (US$ million)**	**Year**	**Amt. (US$ million)**
1991	129	2000	4029
1992	315	2001	6130
1993	586	2002	5035
1994	1314	2003	4322
1995	2144	2004	6051
1996	2821	2005	8961
1997	3557	2006	22826
1998	2462	2007	34362
1999	2155	2008	33613



RESEARCH METHODOLOGY

This research is a descriptive study in nature. The secondary data was collected from various journals, magazines, and websites particularly from the Department of Industrial Policy & Promotion, Ministry of Commerce and Industry, India stat etc. The study is based on the time period from 2000-2010. Simple percentages have been used to defect the growth rate of India and world GDP and to draw further comparison between the two. Graphs and tables have also been used where ever required to depict statistical data of FDI during the study period.

OBJECTIVES

The study covers the following objectives:

1. To study the trends and patterns of flow of FDI.
2. To assess the determinants of FDI inflows.
3. To evaluate the impact of FDI on the Economy.

LIMITATIONS OF THE STUDY

All the economic/scientific studies are faced with various limitations and this study is no exception to the phenomena. The various limitations of the study are:

1. At various stages, the basic objective of the study is suffered due to inadequacy of time series data from related agencies. There has also been a problem of sufficient homogenous data from different sources. For example, the time series used for

different variables, the averages are used at certain occasions. Therefore, the trends, growth rates and estimated regression coefficients may deviate from the true ones.

2. The assumption that FDI was the only cause for development of Indian economy in the post liberalized period is debatable. No proper methods were available to segregate the effect of FDI to support the validity of this assumption.
3. Above all, since it is a research paper and the research was faced with the problem of various resources like time and money.

Determinants of FDI

The determinant varies from one country to another due their unique characteristics and opportunities for the potential investors. In specific the determinants of FDI in India are:

1. **Stable policies:** India stable economic and socio policies have attracted investors across border. Investors prefer countries which stable economic policies. If the government makes changes in policies which will have effect on the business. The business requires a lot of funds to be deployed and any change in policy against the investor will have a negative effect.
2. **Economic factors:** Different economic factors encourage inward FDI. These include interest loans, tax breaks, grants, subsidies and the removal of restrictions and limitation. The government of India has given many tax exemption and subsidies to the foreign investors who would help in developing the economy.
3. **Cheap and skilled labor:** There is abundant labor available in India in terms of skilled and unskilled human resources. Foreign investors will to take advantage of the difference in the cost of labor as we have cheap and skilled labors. Example: Foreign firms have invested in BPO's in India which require skilled labor and we have been providing the same.
4. **Basic Infrastructure:** India though is a developing country, it has developed special economic zone where there have focused to build required infrastructure such as roads, effective transportation and registered carrier departure worldwide, Information and communication network/technology, powers, financial institutions, and legal system and other basic amenities which are must for the success of the business. A sound legal system and modern infrastructure supporting an efficient distribution of goods and services in the host country.
5. **Unexplored Markets:** In India there is large scope for the investors because there is a large section of markets have not explored or unutilized. In India there is enormous potential customer market with large middle class income group who would be target group for new markets. Example: BPO was one sector where the investors had large scope exploring the markets where the service was provided with just a call, with almost customer satisfaction.
6. **Availability of Natural Resources:** As we that India has large volume of natural resources such as coal, iron ore, Natural gas etc. If natural resources are available they can be used in production process or for extraction of mines by the foreign investors.

Impact on Indian Economy

FDI have helped India to attain a financial stability and economic growth with the help of investments in different sectors. FDI has boosted the economic life of India and on the other hand there are critics who have blamed the government for ousting the domestic inflows. After liberalization of Trade policies in India, there has been a positive GDP growth rate in Indian economy. Foreign direct investments helps in developing the economy by generating employment to the unemployed, Generating revenues in the form of tax and incomes, Financial stability to the government, development of infrastructure, backward and forward linkages to the domestic firms for the requirements of raw materials, tools, business infrastructure, and act as support for financial system. Forward and back ward linkages are developed to support the foreign firm with supply of raw and other requirements. It helps in generation of employment and also helps poverty eradication. There are many businesses or individuals who would earn their lively hood through the foreign investments. There are legal and financial consultants who also guide in the early stage of establishment of firm. It is the world largest democracy and crown at an impressive rate of over 6 percent, on an average per annum in the last decades. The number of proposal approved by the foreign investment board from the period of February 2003 to December 2009 were 3511 proposals and the proposed inflows of foreign direct investment is 194708.83 (₹ in crores). During 2009 alone FIPB approved 300 proposals with FDI inflow of ₹ 404111 crores. In the thirteenth round second quarter of financial year 2011 of the professional forecasters survey conducted by the RBI, expects the real GDP growth to be marginally higher at 8.5 percent in financial year 2011 from the last survey.

Employment

There is direct and positive relationship between FDI and employment. As firms are operated in India they require skilled and unskilled labour. In India labour is cheap source and available in abundant. Therefore, FDI provides employment to all the section of the people. They contribute a good proportionate of the total employment. Normally Greenfield's generates employment when they start a project or firm but mergers and acquisitions do not generate employment at the time of entry but over the period it creates employment and also develops trade linkages in the long run. One of the objectives of development of special economic zones is generation of employment. More than two-fifth of the market capitalization originates in Class-3 cities. FDI-enabled firms in manufacturing sectors provide employment to about 15.6 lakhs persons, accounting for about 4 to 5% of the total employment in the organized sector. Class-3 cities provide employment to about 7.9 lakhs workers (more than 50% of the total). Sectors providing a relatively high share of employment in Class-3 cities include transport equipment; growing and processing of crops; construction parts; textiles; and non-metallic mineral products.

Investment Proposal and Foreign Technology Collaborations

Foreign technology induction can be encouraged through FDI and through foreign technology collaboration agreements. The sectors which have resources but do not have the required technology acquire foreign technology collaboration through RBI or Government approvals. The total number of approvals recorded for the period of 2000 to 2010 by the RBI, SIA and FIPB is 8080. The RBI has approved 4580 proposal whereas SIA and FIPB have approved 3500. Technical collaborations have put a positive effect on the domestic firms. It helped in establishing technology transfers. Electrical equipments have recorded with 15.6% of the total approvals of foreign technology collaborations. Followed by chemicals, industrial machinery, transport industries, miscellaneous mechanical and engineering, metallurgical industry, Fuel, drugs and pharmaceuticals, hotel and tourism, textiles and other industries have been approved with a share of 11.2, 10.8, 9.4, 5.4, 4.7, 5, 3.4, 3.6, 2.1 and 23.5% respectively. Most of the sectors which have been approved are manufacturing sector requiring high technology.

CONCLUSION

This paper focuses on theoretical aspects of FDI in India during the last ten years, determinants and need of FDI in Indian scenario. India has been one of the developing countries and has managed to show a positive GDP growth even during the recession period. It has comparatively performed well, then the average growth rate of world GDP. According to UNCTAD in its World Investment Report 2010 "If the situation continues to improve, India is likely to be among the most promising investor-home countries in 2010-12 as well as the third highest economy for FDI in 2010-12". India has all the variables such as fine infrastructure, potential markets, abundant labour, availability of natural resources, and at last the economic and trades policies which has been favouring FDI. India is now rated as the second-most favoured destination for FDI in the world after China, but it is expected that in future India would out beet china as it has a large proportion of young population with one of the fastest growing economies. Instead of the government should formulate the policies which can attract more foreign investment in manufacturing sector rather than service sector.

REFERENCES

1. Banga, Rashmi (2003), "Impact of Government Policies and Investment Agreements on FDI Inflows', Working Paper no. 116, November 2003, Indian Council for Research on International Economic Relations: Delhi.
2. Balasubramnyam V. N. and David Sapsford (2007), "Does India Need a Lot More FDI?" Economic and Political Weekly, April 28, 2007 (pp. 1549-1555).
3. Chadha R and G. Nataraj (2010), "FDI in India and its Growth Linkages", National Council of Applied Economic Research, New Delhi.
4. Sharma Kishore (2000), "Export Growth in India: Has FDI Played a Role?", Center Discussion Paper no. 816, Economic Growth Center, Yale University, July 2000.
5. Kumar Nagesh (2007), "Liberalization, Foreign Direct Investment Flows and Development", Economic and Political Weekly, April 28, 2007 (pp. 1459-1468).
6. Vishal Shah, Alka Parikh, Int. J. Eco. Res., 2012, 134 - 144 ISSN: 2229-6158 IJER.
7. Government of India (GOI), (2006). Foreign Direct Investment Policy, Ministry of Commerce and Industry, Department of Industrial Policy and Promotion.
8. Government of India (GOI) (2007). FDI Statistics, Ministry of Commerce & Industry, Department of Industrial Policy and Promotion.
9. Ahluwalia, Isher (1985): Industrial Growth in India - Stagnation since the Mid-Sixties, Oxford University Press, Delhi.
10. Amsden, Alice (2001): The Rise of 'The Rest': Challenges to the West From Late-Industrialising Economies, Oxford University Press, New York.

ISSN – 2320-0073 Volume II, March'13

11. Rao, K S Chalapati, Murthy, M R and Ranganathan, K V K (1999): 'Foreign Direct Investment in the Post-Liberalisation Period: An Overview', Journal of Indian School of Political Economy, Vol 11, No 3, Jul-Sept.
12. Rao, Chalapati K S and Murthy, M R (1999): 'Foreign Direct Investment' in Alternative Economic Survey, 1991-98: Seven Years of Structural Adjustment, Alternative Survey Group, New Delhi. Reserve Bank of India (2001): Handbook of Statistics on Indian Economy, Mumbai.
13. Rocha, Geisa Maria (2002): 'Neo-Dependency in Brazil', New Left Review, No 16, July-August. Srinivassan, G (2002): 'Secret of China's FDI Riches', Business Line, December 6, 2002.
14. Subramaniam, K K (1991): 'Technological Capability under Economic Liberalism: Experience of Indian Industry in the Eighties', Economic and Political Weekly, Vol 26, No 35, August 31.
15. Tseng, Wanda and Harm Zebregs (2002): 'Foreign Direct Investment in China: Some Lessons for other Countries', IMF Policy Discussion Paper (PDP/02/03), Washington DC.
16. Wells, Louis T and Gleason, Eric S (1995): 'Is Foreign Infrastructure Investment Still too Risky?', Harvard Business Review, September- October. World Bank (1993): The East Asian Miracle: Economic Growth And Public Policy, Oxford University Press, New York.

Websites

1. www.google.co.in
2. www.wikepedia.com
3. www.rbi.org.in
4. www.gov.in