RESEARCH PAPER | Finance | Volume : 4 | Issue : 4 | Special Apr Issue 2014 | ISSN - 2249-555X

Foreign Direct Investment: Features, Flow and Regulatory Mechanism in India

KEYWORDS: foreign investment, capital, domestic savings, economy.

Dr.P.S.VIJAYA LAKSHMI

Deputy Director – COADE, Periyar Maniammai University, Thanjavur

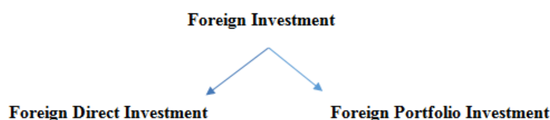
ABSTRACT *Foreign Direct Investment plays a vital role in economic growth of a country as it raises the economy's output and improves standard of living of the people. Further, FDI flows played an important role in the early post-Independence Indian era via technology and capital from abroad. Since the availability of capital is scarce in many countries due to low rate of domestic savings, the importance of foreign investment is ever increasing. In the liberalized global environment as economies become increasingly open and trade among countries expand, financial transactions become global through financing trade of goods and services. Capital is the engine of economic development and hence both developed and developing countries are trying their best to undertake investment programmes by attracting foreign capital. In this context, it is essential to know the meaning, nature, features, flow and controlling mechanism of FDI in India. This paper throws light on the above aspects.*

INTRODUCTION

Foreign capital consists of foreign public and private capitals. Public foreign capital is otherwise known as foreign aid whereas private foreign capital consists of either direct or indirect foreign investment. Foreign investments involve transfer of financial resources such as, technology and other skills from one country to another. Foreign investment not only brings in capital, but also carries with it managerial ability, technical knowledge, technical personnel, innovations in products and production techniques and hence help the development of infrastructure and demand creation and in turn additional domestic investment. Broadly there are two types of foreign investments namely Foreign Direct Investment (FDI) and Foreign Portfolio Investment (FPI).

CLASSIFICATION OF FOREIGN INVERSTMENTS

Foreign investments may be classified as follows:



Foreign Direct Investment: Foreign Direct Investment happens in a country where the investor retains control over the investment. It typically takes the form of sharing a subsidiary, acquiring a stake in an existing firm or starting a joint venture in the foreign country. Direct investment and management of the firm concerned normally go together.

Foreign Portfolio Investment: Foreign portfolio investment is an investment in the share and debt securities of companies abroad in the secondary market nearly for sake of returns and not in the interests of the management of a company. Foreign portfolio investments in the economy tend to develop capital market. The flow of Portfolio investment in primary market provides direct finance to domestic companies without controlling power. When this investment is made in the secondary market, it raises the prices of equity thus, declining the cost of raising capital thereby encouraging new equity issues. Portfolio investment increases the liquidity in the stock market. Since portfolio investment represents short-term inflow of capital therefore, it creates volatility in stock as well as in the foreign exchange markets. In recent years, the portfolio investment has been encouraged to attract more capital flows into the economy. The details are given in Table – 1.

As given in Table 1, the overall foreign investment in India from 1992 to 2011 stood at US $ millions 3,48,854 in which the respective shares of the foreign direct investment and foreign portfolio investment formed 59.38% and 40.62%. It is found that the foreign portfolio investment were negative during 1999 and 2009. The inflows were helpful in aiding the economy for her development.

In India mainly there are three routes for such investments:
(i) Foreign Institutional Investors (FIIs) like mutual funds.
(ii) Global Depository Receipts (GDRs).
(iii) Foreign Currency Convertible Bonds (FCCBs).

GDRs and FCCBs are investments issued by Indian companies in the European markets for mobilizing foreign capital by facilitating portfolio investment by foreigners in Indian securities.

Table-1: Inflow of Foreign Investment in India - 1992-2011(in U S $ millions)

Year	FDI	FPI	Total
(1)	(2)	(3)	(4)
1992	129	4	133
1993	315	244	559
1994	386	3567	4153
1995	1314	3824	5138
1996	2144	2748	4892
1997	2821	3312	6133
1998	3557	1828	5385
1999	2462	-61	2401
2000	2155	3026	5181
2001	4029	2760	6789
2002	6130	2021	8151
2003	5035	979	6014
2004	4322	11,377	15,699
2005	6051	9315	15,366
2006	8961	12,492	21,453
2007	22,826	7003	29,829
2008	34,360	27,271	61,631
2009	35,168	-13,855	21,313
2010	37,763	32,376	70,139
2011	27,024	31,471	58,495
Overall Total	2,07,152	1,41,702	3,48,854
Percentage	59.38	40.62	100

Source: RBI Monthly Bulletin, November 2001, p. S1148.
RBI Monthly Bulletin, May 2011, p. S960.

Volume : 4 | Issue : 4 | Special Apr Issue 2014 | ISSN - 2249-555X

MEANING AND CHARACTERISTICS OF FDI

According to IMF guidelines, FDI is defined as 'a source of capital funds from host country's point of view as it need not necessarily imply immediate addition to plant and machinery or stock".

Generally speaking FDI refers to capital inflows 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 depend on the performance of the projects financed by the investors. FDI also facilitates international trade and transfer of knowledge, skills and technology.

CHARACTERISTICS

The following are the positive characteristics of Foreign Direct Investment (FDI):

(1) Foreign investment can fill the gap between desired investment and locally mobilized savings. Local capital markets are often not well developed. Thus, they cannot meet the capital requirements for large investment projects. Besides, access to the hard currency, needed to purchase investment goods not available locally, can be difficult. FDI solves both these problems at once, as it is a direct source of external capital. It can fill desired foreign exchange requirements, apart from net export earnings.

(2) Foreign investment can supply a package of needed resources such as management experience, entrepreneurial abilities, organizational and technological skills/knowledge, while transferring machinery and equipment to developing countries and help replacing outdated equipment and techniques that can increasethe productivity of workers and production of standard goods. The ability of domestic producers is enhanced to compete globally for export markets.

(3) Foreign investment can create employment in the modern sectors of developing countries.

(4) It can benefit consumers in Low-Developed Countries (LDCs) through lower prices / improved quality of goods and new products.

(5) Foreign investment can stimulate domestic investment through forward and backward linkages. For example, output of a foreign firm can be an input of domestic and vice-versa industries. If this is so, foreign firms create demand for industries producing goods needed by them.

Some of the negative characteristics are:

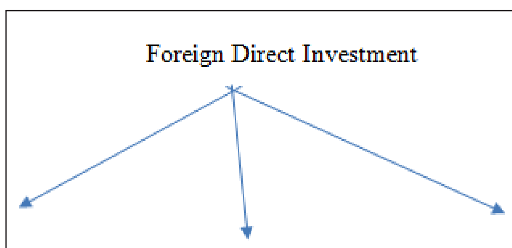
(1) Foreign investment contributed to under development of India by concentrating on the production and export of raw materials and foodstuffs.

(2) It went into sectors, which catered to foreign markets and not Indian home market.

(3) The multiplier effects in terms of income, employment, capital; technical knowledge and growth of external economies of these investments were largely exported back to developed countries.

CLASSIFICATION OF FOREIGN DIRECT INVESTMENT:

Foreign Direct Investment (FDI) has been classified in a following manner:



Green field investment is an investment in the equity capital of a company abroad for the sake of the management of the company or investment abroad through opening of the branches.

Merger and acquisitions are either out-right purchase of a running company abroad or an amalgamation with a running foreign company.

Brown field investment is used to denote a combination of green field investment and merger and acquisitions. It is found in case of a firm's acquisition that it completely replaces the plant and equipment, labour and product line.

CORPORATE FORMS OF FDI

According to the extent of foreign shareholding, corporate forms of foreign direct investments in India are detailed below:

Extent of Foreign Shareholding	Corporate Form of FDI
100%	Fully owned subsidiary
> 50% but < 100%	Subsidiary or majority foreign owned
50%	Co-owned company
> 25% but < 50%	Minority foreign owned company

COMPONENTS OF FOREIGN DIRECT INVESTMENT (FDI)

There are three components of FDI, namely, equity capital, reinvested earnings and intra-company loans.

(1) Equity capital is the foreign direct investor's purchase of shares of an enterprise in a country other than his own country.

(2) Reinvested earnings comprise the direct investor's share (in proportion to direct equity participation) of earnings not distributed as dividends by affiliated or earnings, not remitted to the direct investor such retained profits by affiliates are re-invested.

(3) Intra-company loans or intra-company debt transactions refer to short or long term borrowing and lending of funds between direct investors (parent enterprises) and affiliate enterprises. The details of such investments are presented in Table – 2.

As shown Table -2, there was equity flow between 1992 and 2000 to the tune of U S $ 15,483, while all the three kinds' flows were seen between 2001 and 2011. The respective shares of equity, reinvestment earnings and other capitals constituted 72.88%, 23.93%, 3.19%.

ROUTES FOR FOREIGN DIRECT INVESTMENT (FDI) FLOW

FDI can be approved either through the automatic route or by the government route.

1. Automatic route

Companies proposing foreign investment under the automatic route do not require any government approval, provided the proposed foreign equity is within the specified ceiling and the requisite documents are filed with the Reserve Bank of India (RBI) within 30 days of receipt of funds. The automatic route encompasses all proposals.

(a) wherein the foreign investment in the equity capital of the Indian company is up to 50/51/74/100 percent as the case may be as applicable to the list of high priority industries, and

(b) wherein the proposed items of manufacture / activity do not require an industrial license and is not reserved for the small scale sector.

Volume : 4 | Issue : 4 | Special Apr Issue 2014 | ISSN - 2249-555X

Table - 2: Component wise FDI - 1992-2011(in US $ millions)

Years	Equity	Reinvestment earnings	Other capital	Total
(1)	(2)	(3)	(4)	(5)
1992	129	-	-	129
1993	315	-	-	315
1994	586	-	-	586
1995	1314	-	-	1314
1996	2144	-	-	2144
1997	2821	-	-	2821
1998	3557	-	-	3557
1999	2462	-	-	2462
2000	2155	-	-	2155
Total (upto2000)	15483	-	-	15483
2001	2400	1350	279	4029
2002	4095	1645	390	6130
2003	2764	1833	438	5035
2004	2229	1460	633	4322
2005	3778	1904	369	6051
2006	5975	2760	226	8961
2007	16481	5828	517	22826
2008	26865	7168	327	34360
2009	27495	6426	747	34668
2010	27149	8669	1945	37763
2011	20087	6703	234	27024
Overall Total (2001 – 2011)	1,39,318	45,746	6105	1,91,169
Percentage	72.88	23.93	3.19	100

Source: RBI Monthly Bulletin, November 2001, p. S1148.
RBI Monthly Bulletin, May 2011, p. S960.

The above is also applicable for existing companies desiring to raise foreign equity up to 50/51/74/100 percent, as the case may be. If the equity is proposed as part of an expansion programme, the expansion programme must be in the high priority industries. When the increase in equity is not proposed for purposes of an expansion, the company must be pre-dominantly engaged in the high priority industries.

The automatic route for FDI and / or technology collaboration would not be available to those who have on hand any previous joint venture on technology transfer / trademark agreement in the same or allied field in India.

2. Government approval
For the following categories, government approval for FDI through the FIPB (Foreign Investment Promotion Board) would be necessary:

(a) for proposals attracting compulsory licensing;

(b) for items of manufacture reserved for the small-scale sector;

(c) for acquisition of existing shares;

(d) for foreign investment proposals where the parameters for automatic approval are not met and the company has to notify the same to SIA (Secretarial for Industrial Assistance) within 30 days of receipt of funds and also regarding allotment of shares; and

(e) in case of infusion of foreign equity by a company without changing the percentage of equity that has already been approved by the government and where the original project cost was up to Rs. 600crore, no prior approval of FIPB / Government is required. The company has to notify the same to SIA within 30 days of receipt of funds and also regarding allotment of shares.

REGULATORY FRAMEWORK OF FDI IN INDIA

1. Foreign Investment Promotion Board (FIPB)

Composition
FIPB is a high-powered board operating under the Ministry of Industry. This is specially empowered to engage in purposive negotiations and also consider approvals in totality, free from predetermined parameters on procedures.

The reconstituted FIPB comprises a Chairman and three members. The Board would be able to co-opt Secretaries and other top officials of financial institutions, banks and professional experts of industry and commerce, as and when necessary.

Guidelines
The criteria normally considered for granting approvals are included

(i) The extent of capital needed for the project, (ii) The nature and quality of technology, (iii) The requirements of marketing and management skills, and (iv) The commitment for exports.

As per the recent guidelines, FIPB may consider proposals for 100 percent foreign equity based on the criteria:

(i) where only holding operations are involved and all subsequent downstream investments to be carried out would require prior approval from the Government; (ii) where proprietary technology is sought to be protected or sophisticated technology is proposed to be brought in; (iii) where at least 50 percent of the production is exported; and (iv) 100 percent may be granted on a temporary basis provided the foreign investor divests at least 26 percent equity stake to India parties within a period of 3 to 5 years.In particular, approval time has been confined to 30 days.

2. Foreign Investment Implementation Authority (FIIA)
The GoIestablished on August 9, 1999 to facilitate quick implementation of FDI approvals and assist foreign investors in getting necessary approvals.

3. Foreign Investment Promotional Council (FIPC):
The Government has constituted a Foreign Investment Promotion Council (FIPC) in the Ministry of Industry to have more target oriented approach towards foreign direct investment promotion.

4. Insurance Regulatory and Development Act (IRDA):
An Insurance Regulatory and Development Act (IRDA) was passed by the Parliament in December 1999. The Act seeks to promote private sector participation in the Insurance Sector and permits foreign equity stake in domestic private insurance companies up to maximum of 26 percent of the total paid-up capital.

In February 2000, Government took a major decision to place all items under the automatic route for FDI / NRI / OCB investment.

5. Investment Commission:
The Cabinet Committee on Economic Affairs (CCEA) approved the proposal for the creation of an Investment Commission on 27th October 2004, located in the Finance Ministry, enjoying operational autonomy and Government support with one Chairperson, two members and three professional groups for a three year term to act as a facilitation group between the potential investors and the official machinery so that investments in India would rise significantly, besides making recommendations to the Government on policy and procedures to facilitate greater foreign direct investment (FDI) flows into India.

Volume : 4 | Issue : 4 | Special Apr Issue 2014 | ISSN - 2249-555X

REFERENCE Journal References | Dutta M.K (2001) "Foreign Direct Investment in India Since 1991: Trends, Challenges And Prospects" Journal of Finance | Priya (2002) "FDI inflows into India slip, despite best efforts" Journal of Finance | Ahmad Shahnawaz (2002) "FDI in India" Journal of Finance | Mohanty B.K (2003) "FDI inflows into Retail Revolution- emerging dimensions for rural upliftment" The Management Accountant, Vol.20, No.5, 2003 | RajnishTiwari (2007) "India's policies to attract FDI in R&D" The Management Accountant, Vol.40, No.7, 2007 | Shiralashetti A S (2008) "Foreign Direct investment and Economic Growth of India" Journal of Finance | Kameswari P (2008) "FDI and its role in Developing Indian Economy" Journal of Finance | Pardeep Kumar (2011) "Impact of FDI on GDP – A Critical Evaluation" VSRD-IJBMR, Vol. 1 (2), 2011, 103-114. | Syed Azhar, K.N.Marimuthu (2012) "An Overview of Foreign Direct Investment in India", International Journal of Business Economics & Management Research Vol.2 Issue 1, January 2012, ISSN 2249 8826 83 | Reports | Reserve Bank of India (2012) RBI, Handbook of Statistics on the Indian Economy | Reserve Bank of India (2012) RBI, Reports on Currency and Finance | Ministry of Commerce & Industry (1998), "Guidelines – Non-Banking Financial Companies (NBFCs)", DIPP (FC Section), Press Note No. 16. | Ministry of Commerce & Industry (1999), "Increase in Foreign Equity", DIPP (FC Section), Press Note No. 7. | Ministry of Commerce & Industry (2004), "Sectoral Guidelines and Equity Cap Review", DIPP (FC Section), Press Note No. 1. | Ministry of Commerce & Industry (2006), "FDI in Up-linking of TV Channels", DIPP (FC Section), Press Note No. 1. | | Magazine/News Paper | | India Today, September 30, 2002. | The Financial Express, December 23, 2008, p. 5. |