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Foreign Direct Investment And Indian Economy

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ABSTRACT *Foreign direct investment (FDI) is widely believed as a catalyst for the economic development in developing countries. It is preferred over all foreign capital flows. It is considered as an important source of growth since it is a non-debt capital inflow. This paper is an attempt to throw some light on the bumpy beginnings of FDI in Indian economy. After economic reforms of 1991, many changes were introduced in the India's foreign policy. Against this backdrop, this paper highlights the vital determinants of FDI in India as propagated by many scholars. It presents a historical perspective over the evolution of FDI in India and also envisages discussing the advantages and disadvantages of FDI inflow with reference to the Indian economy. Finally, it offers an outline of the current FDI policy in Indian Economy and the paves way to the future prospects.*

Introduction

In the present era of globalisation and stiff competition, Foreign Direct Investment (FDI) has evolved at a greater pace and has assumed significant importance for the producers, consumers and other agents of the economy involving the government itself. FDI integrates the financial world markets and paves the way for greater development strategy. It is acknowledged as a win-win situation for both the host and the home countries. Whereas the home countries cherish to garner the benefit of the enormous markets unfastened by industrial growth, the host countries desire to attain managerial and technological abilities and complement their foreign exchange reserves and domestic saving rates. But the opponents of FDI consider it to be disadvantageous as it involves tremendous risk in the form of financial resources. Also the foreign company tends to maintain its autonomy in the domestic market which destroys domestic economy's national politics. The study of FDI seems vital and therefore, this paper attempts to shed light on the FDI policy in Indian Economy. This paper highlights the vital determinants of FDI in India as propagated by many scholars. It presents a historical perspective over the evolution of FDI in India and also envisages discussing the advantages and disadvantages of FDI inflow with reference to the Indian economy. Finally, it offers an outline of the current FDI policy in Indian Economy and the paves way to the future prospects.

A historical Perspective

Foreign Direct Investment is defined as an investment in a foreign land where the investor retains sufficient control over the investment made. As stated by IMF, FDI is a form of international investment that involves a long term relationship and long lasting interest in an organisation in another country (Bandelji, 2002). According to Lall (2002) it satisfies the objectives of the host country and the investors to a great extent. For the past few decades India has continuously witnessed a massive increase in FDI inflows (UNCTAD, 2010). Since then FDI has become a magic wand that will transmute Indian economy into a modern economy with better and equipped infrastructure. In India, since 1970's, plethora of financial institutions which are in favour of FDI inflow have continuously amended their policies in tune with the changing market situations. As pointed out by Shin (2014) India's policy towards FDI inflows has undergone four phases which have been elucidated below:

First Phase 1950-1967

With the implementation of second five year plan, India's development policy drifted towards import substitution industrialization. The period was characterized by receptive attitude towards FDI and was built on mutually advantageous terms. Since foreign capital was considered essential, foreign investors were treated at par with domestic investors, though majority local ownership and control was in Indian hands. There were no constraints on remittances of profits and dividends with proper protection guaranteed to the local production in the domestic market. Hence cautious welcome was given to FDI.

Second Phase 1967-1980

This period witnessed considerable investment in many industries. India's manpower was becoming more skilled and restrictions on entrepreneurship had begun to ease. Moreover, servicing of FDI and technology imports in the form of dividends, profits, and royalties tended to increase. This forced the government to enact restrictive and selective policies towards FDI. From 1973 onwards, Foreign Exchange Regulation Act (FERA) became a draconian law. It controlled FDI inflows through tight regulation. Also the renewals of many foreign agreements were limited.

Third Phase 1980-1990

This phase observed gradual liberalization of FDI policies due to deterioration of foreign exchange reserves and the lack of required boost to India's manufactured products. Therefore, eighties perceived easing of restrictions on foreign investment flows with liberalization of industrial and trade policies. During this period, policies were designed to allure FDI and many approval systems were streamlined. The rules and regulations concerning payment of royalties and other fees were reduced. In 1988, a channel was set up to expedite clearances of FDI from many investing countries.

Fourth Phase - 1991 onwards

This period witnessed a paradigm shift in the policies of FDI with the adoption of Industrial policy statement of 1991. The policies were liberalized relating to technology, collaboration, foreign trade and foreign exchange. In 1999, FERA was replaced with FEMA. Government permitted, except for small negative list, operation of automatic route to FDI. Also FDI through mergers and acquisitions were

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agreed upon.

Determinants of FDI in Indian economy

The parameters which have attracted large FDI inflows in India can be substantiated by various studies. For instance, as mentioned by Jackson and et al (1995) labour cost, institutional framework, quality of physical and human infrastructure, macroeconomic environment and the size of the market are major factors that influence the inflow of FDI. Besides this, Schneider and et al (1985) pointed out some additional factors such as general law and order, political stability, trained and productive workforce and timely FDI clearance as the determinants of FDI. According to Bose (2012) India possesses a large market size, cheap labour force and easy availability of diversified resources with proper regulator and investment protective framework which make it an attractive destination for FDI inflow after China.

Advantages of FDI in Indian Economy

In the global economy India is an important destination for FDI inflow due to the above mentioned determinants. It is known that opening up to the Foreign Direct Investment in 1990's has been a key driver to boost the growth potential of Indian Economy. FDI has the capacity to provide the Indian economy with new marketing channels; least cost production facilities; access to superior technology, financing and skills and enhanced opportunities for joint ventures with domestic partners. The following few factors determine the advantages of FDI in India.

Fills the Investment gap and raises the level of investment

FDI is acknowledged as an investment directly into the production of a country's company by a foreign company thereby increasing the operations of the business in the domestic country. So it benefits both the host and the home country by garnering immense profit from the venture. Also, it is widely known that capital formation is a vital factor of economic growth. But Indian local capital markets are often not well developed and cannot meet the financial requirements for large profitable investment projects. So FDI comes to the rescue and solves the problem as it is a direct source of capital (Kaur, 2014). Whereas domestic investments strengthen the domestic capital stock of an economy, FDI plays an important part in boosting the capital formation by bridging the gap between domestic savings and investment and stimulating productivity - led growth. This way India's investment gap has been filled by the FDI inflow and it is now perceived to be an attractive destination for FDI by many foreign investors.

Impact on employment generation

FDI is supposed to create employment possibilities in varied sectors of Indian economy. With its entry FDI brings in enhanced and improved production capacity which engenders new jobs in the domestic country. Along with providing employment FDI also improves the productivity of many existing enterprises. Since, India is endowed with cheap supply of labour so inflow of FDI provides employment to majority of its workforce. In addition to this FDI inflow in India has created many special economic zones (SEZ's) which in turn have been responsible for enhancing employment possibilities in the country. As pointed out by the study of Someshu (2015) estimates suggest that FDI in the manufacturing has a record of generating 4-5% of the total employment potential.

Increased Technical know-how

FDI helps in improving the productivity, efficiency, management of industrial and manufacturing products by the inflow of modern technology which enhances the technical efficiency of the domestic economy. FDI brings in state-of-the-art technology and the technical know-how to India. Such superior technical expertise helps the domestic economy in upgrading its existing infrastructure and management processes. In the absence of FDI India would have used outdated technology and obsolete equipment which would have reduced the productivity of the country and resulted in low quality products. According to Vasanthi & Aarthi (2013) FDI has transferred new machinery and equipment which has raised the asset generating capacity of the country.

Increased competitiveness

As FDI brings in superior technology and managerial know-how it tends to increase the competition in the Indian economy. With the presence of foreign companies, other domestic companies existing in the market improve their production process in order to stay at par with the foreign entity as rightly pointed out by Shruti (2013) . This way FDI improves the quality of products in a particular sector. This creates a domino effect in other sectors too. As a result the entire industry turns competitive and brings in the production of high quality products. By increasing the standard of product quality FDI creates a favourable impact on India's export competitiveness. This in turn creates an increased demand for India's export in the world market and boosts its growth potential.

Disadvantages of FDI in Indian Economy

The positive impacts of FDI are practically correct but when we go deep into the ground reality, we decipher that all is not rosy as we imagine it to be. FDI inflow into Indian economy is not without flaws and demerits. Some of the disadvantages of the FDI inflow in Indian economy has been discussed below.

Negative impact on environment

The relationship between FDI inflow and its possible effects on environment is highly debated issue. The study of Acharya (2009), reveals that FDI is attracted to those countries which have not very stringent laws and regulations on environment and natural resources. Low standard of environmental regulation in developing countries like India results in 'dirty industries' move their production process to these countries. Due to this the pollution level in the developing country may escalate and this is likely to negatively impact the environment of the developing country. If such process is allowed to continue environmental damages may increase in future with the increasing inflow of FDI.

Increasing regional inequality

As pointed out by Dunning (1998) while entering the domestic economy Foreign Direct Investment does not move in equally into all the sectors of the economy. There is a massive degree of FDI concentration in few sectors of the Indian economy relative to other sectors. This leads to ever increasing regional inequality in FDI inflows in India. A wide disparity is seen in FDI inflow among different states of the Indian Economy. FDI is seen to be highly concentrated in top six states namely Maharashtra, New Delhi, Tamil Nadu, Karnataka, Gujarat and Andhra Pradesh. Such disparity created regional inequality and has been the result for uneven growth of Indian states.

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Highly volatile nature of FDI inflow

Foreign Direct Investment is regarded as a highly volatile form of international investment which easily gets influenced by the external or internal forces. Therefore it is rightly called as 'hot money flow'. Whereas on one hand FDI inflow brings in competitiveness, efficiency and productivity in the economy, the FDI outflow causes more disaster as can be envisaged. The outflow of FDI results in such a large vacuum which cannot be filled by any replacement in near future. It erodes the investor sentiments, causes high speculation in the markets and reduces the ease of doing business environment. As has been stated by Krugman & Obstfeld (2009) during the period of Global Financial Crisis the outflow of FDI from Indian economy resulted in massive stock market crash, depreciation of Indian rupee, liquidity crunch and negative impact of Balance of Payments whose effects were felt for a very long time in future.

Erosion of domestic markets

Theoretically, FDI ushers is great discipline on the incumbent firms by enhancing competition. But it has been argued by Nagaraj (2003) that when foreign firms enter the host country then they tend to take over the dominant position and suppress the local players. This argument can be substantiated by Coca cola's acquirement of domestic market player, Thumps Up's market share. Though the inflow of FDI at that time should have enhanced competition in the domestic market, it actually crowded out the domestic producer and reduced the competition in the market paving way for Coca cola's monopoly.

FDI Policy in India

Under New Industrial Policy of 1991 FDI in India went for a change. Today the responsibility to permit the FDI is lying with both RBI (Reserve Bank of India) and FIPB (Foreign Investment Promotion Board). Govt. of India maintains a list of 42 industries. If any foreign company is interested to enter in those 42 industries then it has to take permission of RBI. This methodology is popularly known as Bombay Route. Since this method allows entry of foreign companies without any hassles so it is also known as automatic route. On the other hand, if the foreign country is entering into India in any sector other than those 42 industries then that foreign company has to take permission from FIPB (also known as Delhi Route). If the foreign company is entering with less than Rs. 1000 crore then FIPB gives the permission immediately (Automatic Route). But if the amount is greater than Rs. 1000 crore then approval of Govt. of India is mandatory (Approval Route). However, there are some sectors in which FDI is not allowed even under these two routes. These sectors comprise of Atomic Energy, Lottery Business, Gambling and Betting and Buisness of Chit funds. Govt. of India has authorized Cabinet Committee of Economic Affairs to give the permission for approval route. In 2013, Former Prime Minister, Mr. Manmohan Singh, established National Investment Board (NIB) to give permission to the foreign companies under Approval Route. In the month of December 2013 NIB converted into Cabinet Committee on Investment which is now looking after Approval Route.

Conclusion and Future prospects

The current Prime Minister of India, Mr. Narendra Modi, emphasized effective governance and used the slogan of 'Come, make in India' focusing at India as the global manufacturing hub for foreign investors. He used the term FDI as 'First Develop India' and aimed at improving the ease of doing business by de-licensing and de-regulation and opening up FDI in sectors such as Defense, Construction and Railways. The government has emphasized on some high priority sectors like Aviation, Bio-Tech, Construction, Pharmaceuticals and Renewable Energy Industries as the destination of FDI. These initiatives show that government has strong belief in the positive impact of FDI inflows to Indian industry.

To summarise, FDI has created immense opportunities for the development potential of Indian economy and has aided to strengthen the performance of local as well as foreign firms. This has without any doubt raised the status of India among various other developing countries. The positive effects of FDI have been manifold. It has raised the growth rate of Indian GDP, created new employment opportunities, provided the ground for better technical and managerial superiority and raised export competitiveness. But the FDI inflow in India is not without pitfalls. The inflow of foreign companies have suppressed the domestic producers markets and eroded competition, lack of strict environmental regulation has enabled the foreign entities to pollute the Indian environment and negatively impacted climate change. However, in the present era of globalised world we cannot turn a blind eye to FDI inflows and restrict their entry into the domestic markets. Considering the fact they reduce X-inefficiency and herald productivity India must try to minimise the negative effects of FDI inflow and increase the positive effects to reap maximum benefits from Foreign Direct Investment.

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