

Determinants and Impact of Foreign Direct Investments in India



Finance

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ABSTRACT

Foreign Direct Investment is considered to be a major source of funds which may contribute in increasing the economic growth rate in developing countries. Foreign direct investment helps to overtake the problem of low capital, low growth rate, untapped natural and human resources, high rate of inflation, unemployment, balance of payment through exports and remove structural and administrative rigidities mostly experienced in countries like India. This paper gives an overview of factors affecting foreign direct investment and also its impact in India.

INTRODUCTION

Foreign capital and technology have been playing a vital role in India's industrial development. At the time of Independence, India inherited an industrial structure restricted to a few industries like jute, textiles and sugar. Today, the industrial structure has been widely diversified covering broadly the entire range of consumer, intermediate and capital goods. In most of the manufactured products, the country has achieved self-sufficiency with foreign collaboration, but primarily through domestic efforts. This is indicated by the decline in relative share in industrial production of the traditional manufacturing sectors like food and textiles and substantial increase in the production of new goods from engineering and chemicals sectors.

The diversification of industrial structure is further reflected in commodity composition of Indian foreign trade in which the share of imports of manufactured products have become a growing component of exports. The rapid stride in industrialization has been accompanied by corresponding growth in technological and managerial skills obtained from abroad, not only for efficient operation of highly complex and sophisticated industrial enterprises but also for their planning, design and construction.

Foreign capital has also been instrumental in filling the gap between domestic saving and the capital needed for development. Further, foreign capital has helped the country in supplying the much needed foreign exchange thereby filling the foreign exchange gap to a considerable extent.

The foreign exchange gap equals the difference between imports and exports which can be filled by net capital inflows. Foreign capital has been a major factor in India's drive towards self-reliance and import substitution in critical areas. Import substitution has led to diversification of domestic production and consequent reduction in imports for certain critical areas like machinery manufacture, crude oil and petroleum products, infrastructural development, and similar items. The country has been able to export services such as project consultancy, design engineering and project implementation, through the development of indigenous expertise with the help of foreign assistance. Besides, foreign capital has helped in boosting India's exports by modernizing and diversifying her industrial structure, removing structural rigidities.

DETERMINANTS AND FACTORS INFLUENCING FDI IN INDIA

The following are the important factors affecting foreign investment.

(1) Stable Policies: India's stable economic and socio policies have attracted investors across the nations as Investors prefer countries with stable economic policies. If the Government makes frequent changes in policies, then they will affect the business and will have a negative effect.

(2) Fiscal Factors: Different fiscal 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 exemptions and subsidies to the for-

ign investors who would help in developing the economy.

(3) Cheap and Skilled Labour: There is abundant labor available in India in terms of skilled and unskilled human resources. Foreign investors will take advantage of the difference in the cost of labor as we have cheap and skilled labors.

(4) Basic Infrastructure: India, though is a developing country, it has developed special economic zones where they 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 would support 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 still not explored/unutilized. In India there is enormous potential customer market with large middle class income groups who would be target group for new markets wherein the service would be provided with just a call, with almost customer satisfaction.

(6) Availability of Natural Resources: As India has large volume of natural resources such as coal, iron ore, Natural gas etc, they can be used in production process or for extraction of mines by the foreign investors.

(7) Rate of interest: One of the most important stimuli to foreign capital movements is the difference in the rate of interest prevailing at different places. Other things i.e. interest rates or foreign exchange rates being equal, capital has a tendency to move from a country with a low rate of interest to a country where it is higher.

(8) Speculation: Short-term capital movements may be influenced by speculation pertaining to anticipated changes in the interest rates of foreign exchange trade.

(9) Profitability: Private foreign capital movement is influenced by the profit motive. Hence, other things being equal, private capital will be attracted to countries where the return on investment is comparatively higher.

(10) Costs of production: Private capital movements are encouraged by lower costs of production in foreign countries.

(11) Economic conditions: Economic conditions, particularly the market potential and infrastructural facilities, influence private foreign investment. The size of the population and the income level of a country have an important bearing on the market opportunities.

(12) Government policies: Government policies, particularly towards foreign investment, foreign collaboration, remittances, profits, taxation, foreign exchange control, tariffs and monetary, fiscal and other incentives, are important factors that may influence foreign investment in a country.

(13)Political factors: Political factors like political stability, nature of important political parties and relations with other countries also influence capital movements.

FDI AND FOREIGN EXCHANGE RESERVES

India experienced acute shortage of foreign exchange reserves at the end of 1990 and it turned out to be a great problem for India for making international payment. This difficult situation was to be dealt with seriously. A host of liberalization measures was attempted to attract foreign exchange. The flow of foreign exchange in the subsequent years helped India to manage the situation. The details of foreign investment and foreign exchange reserves are given in Table – 3

Table - 1: Foreign Direct Investment and Foreign Exchange Reserves - 1992-2009 (in US \$ millions)

Year	FDI	Forex Reserves	Growth rate
(1)	(2)	(3)	(4)
1992	129	9220	-
1993	315	9832	6.64
1994	586	19254	54.41
1995	1314	25186	57.66
1996	2144	21687	33.80
1997	2821	26423	37.32
1998	3557	29367	36.42
1999	2462	32490	36.06
2000	2155	38036	39.07
2001	4029	42281	39.84
2002	6130	54106	48.68
2003	5035	76100	65.94
2004	4322	112959	93.76
2005	6051	141514	110.37
2006	8961	151622	110.32
2007	22826	199179	137.35
2008	34360	309723	203.70
2009	35168	251985	154.89
CAGR	35.56	20.17	-

Source: Foreign Trade & BOP, CMIE, October 2009, p. 345.

As seen in Table - 1, the inflows of foreign direct investment have increased from US \$129 million US \$ 35168 millions in the period from 1992 to 2009. Inflows of FDI showed fluctuating trends during the period. The decline, as compared to the immediately preceding year, was noticed during 1999,2003,2004 and 2005.The compound annual growth rate for the period stood at 35.56%.

The amount of Forex Reserve has increased from US \$ 9220 million to US \$ 251985 million during the period under study. It has an increasing trend during the same period except the year 2009. It is revealed from the table that the growth rate of Forex Reserve turns out to be 6.64, 54.41, 57.66, 33.80, 37.32, 36.42, 36.06, 39.07, 39.84, 48.68, 65.94, 93.76, 110.37, 110.32, 137.35, 203.70, 154.89 percent during the time period of 1992 to 2009 respectively. The CAGR of Forex Reserve is 20.17 percent during the above said period,while its highest annual growth rate of 203.70 percentage was seen in 2008.

FOREIGN DIRECT INVESTMENT AND EXPORT

The primary expectation was that the FDI should promote export so as to avoid BOP deficits. In order to know the export trends, the details are presented in Table - 2

Table - 2: Foreign Direct Investment and Export - 1992-2009 (in US \$ million)

Year	FDI	Export	Growth Rate
(1)	(2)	(3)	(4)
1992	129	17865	-
1993	315	18537	3.76
1994	586	22238	12.24
1995	1314	26330	15.79
1996	2144	31795	19.49
1997	2821	33470	17.47
1998	3557	35006	15.99
1999	2462	33218	12.28
2000	2155	36822	13.26
2001	4029	44560	16.60
2002	6130	43827	14.53
2003	5035	52719	17.74
2004	4322	63843	21.45
2005	6051	83536	28.28
2006	8961	103090	34.08
2007	22826	126414	40.51
2008	34360	163132	50.82
2009	35168	186903	55.66
CAGR	35.56%	13.93%	-

Source: Directorate General of Commercial Intelligence and Statistics, Nov. 2009, pp. 199-202.

As given in Table -2, the inflows of Foreign Direct Investment from US \$ 129 millions in the year 1992 to US \$ 2155 millions in the year 2000, registered an increase of 16.71 times on the base year 1992. Inflows of FDI increased upto US \$ 35168 millions in the year 2009 as compared to US \$ 4029 millions in the year 2001 registering an increase of 8.73 times over the base year 2001. Inflows of FDI showed fluctuating trends during the study period. The amount of export has increased from US \$ 17865 million to US \$ 186903 million in the period from 1992 to 2009. It has an increasing trend during the same period with exceptions in 1999 and 2002. It was revealed from the table that the growth rate of exports turns out to be 3.76, 12.24, 15.79, 19.49, 17.47, 15.99, 12.28, 13.26, 16.60, 14.53, 17.74, 21.45, 28.28, 34.08, 40.51, 50.82, 55.66 percent from 1992 to 2009 respectively. The CAGR of export is 13.93 percent in the above said period.

FOREIGN DIRECT INVESTMENT AND BOP

The Balance of Payment was always a problem for developing countries. India is not an exception. Flow of foreign direct investment would certainly help to reduce the intensity of deficits of BOP. In the case of India, the flow of FDI actually helped India to tie over the situation. Hence FDI and BOP data are presented in Table – 3.

Table - 3: Foreign Direct Investment and Balance of Payments in India - 1992-2009 (in US \$ millions)

Year	FDI	BOP	Growth Rate
(1)	(2)	(3)	(4)
1992	129	2599	-
1993	315	-590	-122.70
1994	586	83535	114.20
1995	1314	5787	40.89

1996	2144	-1222	-36.75
1997	2821	6793	32.27
1998	3557	4511	12.26
1999	2462	4222	8.92
2000	2155	6402	18.29
2001	4029	5868	13.98
2002	6130	11757	35.24
2003	5035	16985	50.32
2004	4322	31421	92.41
2005	6051	26159	69.73
2006	8961	15052	34.22
2007	22826	36606	87.23
2008	34360	92164	215.38
2009	35168	-20080	-51.33

Source: Directorate General of Commercial Intelligence and Statistics, Nov. 2009, pp. 210.

The inflow of foreign direct investment, as indicated in Table – 3,

increased from US \$ 129 millions in 1992 to US \$ 35168 millions in 2009. The amount of balance of payment had increased from US \$ 2599 millions in 1992 to US \$ 92164 millions in the year 2008 except the years 1993, 1996 and 2009 with corresponding deficits of US\$ 590,1222 and 20,080 millions and the respective negative growth rates of 122.70%, 36.75% and 51.33%, while for other years with positive growth presents of 114.20, 40.89, 32.27, 12.26, 8.92, 18.29, 13.98, 35.24, 50.32, 92.41, 69.73, 34.22, 87.23, 215.38, respectively for the years 1994, 1995 and from 1997 to 2008 .

The country was able to manage the BOP situations prudently for 14 years and enabled herself to carry on development programmes smoothly. The exceptional years of 1993, 1996 and 2009 were due to political instability as India went for Parliament Elections in 1991, 1996 and 2009.

CONCLUSION

In order to attract more foreign capital, Government of India can consider initiation of good labour laws, transparency in the tax system, reduction of the extra burden of the tax on corporate individuals, suitable tax policy, and land acquisition policy in different regional areas to promote export oriented industries that will create favourable atmosphere for the foreign as well as local investors that will go a long way to avoid BOP crisis in future.

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