Role of Foreign Direct Investment in the Development of Indian Economy

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Abstract

FDI refers to capital inflows from abroad that are invested in or to enhance the production capacity of the economy. Despite globalization, the essential role of foreign direct investment (FDI) in economic development has not changed. However, many mechanisms and dynamics of FDI-assisted development have changed: there is greater variation in the kinds of FDI, the benefits each offers, and the manner in which each interacts with the host economy. FDI seen as an important catalyst for economic growth in the developing countries, it affects the economic growth by stimulating domestic investment, increasing human capital formation and by facilitating the technology transfer in the host countries. The main purpose of the study is to investigate the impact of FDI on economic growth in India, from the period of 1990 to 2011.

Key words: Foreign direct investment, Indian economy, Globalization, transfer technology, economic growth.

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Introduction:

Foreign direct investment (FDI) or foreign investment refers to the net inflows of investment to acquire a lasting management interest (10 percent or more of voting stock) in an enterprise operating in an economy other than that of the investor. It is the sum of equity capital, reinvestment of earnings, other long-term capital, and short-term capital as shown in the balance of payments. It usually involves participation in management, joint-venture, transfer of technology and expertise. There are two types of FDI: inward foreign direct investment and outward foreign direct investment, resulting in a net FDI inflow (positive or negative) and "stock of foreign direct investment", which is the cumulative number for a given period.

Direct investment excludes investment through purchase of shares. FDI is one example of international factor movement. An investment abroad, usually where the company being invested in is controlled by the foreign corporation. The simplest explanation of FDI would be a direct investment by a corporation in a commercial venture in another country. A key to separating this action from involvement in other venture in foreign country is that the business enterprise operates completely outside the economy of the corporation’s home country.

Objectives:

The study covers the following objectives:

- To study the trends and pattern of flow of FDI.
- To assess the determinants of FDI inflows.
- To evaluate the impact of FDI on the Indian economy.
- To know the flow of investment in India

Foreign direct investment in India:

Starting from a baseline of less than USD 1 billion in 1990, a recent UNCTAD survey projected India as the second most important FDI destination (after China) for transnational corporations during 2010-2012. As per the data, the sectors which attracted higher inflows were services, telecommunication, construction activities and computer software and hardware. Mauritius, Singapore, the US and the UK were among the leading sources of FDI.
FDI for 2009-10 at USD 25.88 billion was lower by five per cent from USD 27.33 billion in the previous fiscal. Foreign direct investment in August dipped by about 60 per cent to approx. USD 34 billion, the lowest in 2010 fiscal, industry department data released showed. In the first two months of 2010-11 fiscal FDI inflow into India was at an all-time high of $7.78 billion up 77% from $4.4 billion during the corresponding period in the previous year.

**FDI Policy in India:**

FDI as defined in Dictionary of Economics is investment in a foreign country through the acquisition of a local company or the establishment there of an operation on a new site. To put in simple words, FDI refers to capital inflows from abroad that is invested in or to enhance the production capacity of the economy.

Foreign Investment in India is governed by the FDI policy announced by the Government of India and the provision of the Foreign Exchange Management Act (FEMA) 1999. The Reserve Bank of India (‘RBI’) in this regard had issued a notification, which contains the Foreign Exchange Management (Transfer or issue of security by a person resident outside India) Regulations, 2000. This notification has been amended from time to time. The Ministry of Commerce and Industry, Government of India is the nodal agency for motoring and reviewing the FDI policy on continued basis and changes in sectoral policy/sectoral equity cap. The FDI policy is notified through Press Notes by the Secretariat for Industrial Assistance (SIA), Department of Industrial Policy and Promotion (DIPP). The foreign investors are free to invest in India, except few sectors/activities, where prior approval from the RBI or Foreign Investment Promotion Board (‘FIPB’) would be required.

**FDI and The Host Economy: A Brief Review of The Literature:**

This section reviews the empirical studies on the relation between FDI and economic activities in the host economy, which could facilitate in identifying the issues relating to the impact of FDI at the sartorial level. In the earlier stage, few studies had shown that FDI has a negative impact on the growth of the developing countries (Singer, 1950; Griffin, 1970; Weisskof, 1972). The main argument of these studies was that FDI flows to Less Developing Countries (ldcs) were mainly directed towards the primary sector, which basically promoted the less market value of this sector. Since these primary products are exported to the developed countries and are processed for import, it receives a lower price for its primary product. This could create a base for the
negative impact of FDI flows in the economy. On the other hand, Rodan (1961), Chenery and Strout (1966) in the early 1960s argued that foreign capital inflows have
A study by Kasibhatla and Sawhney (1996) in the U.S. supports a unidirectional causality from GDP to FDI and not the reverse causation. This may be due to the fact that for a developed country, FDI follows GDP, as GDP is an indicator for market size.
Aitken, et al. (1997) showed the external effect of FDI on export with example of Bangladesh, where the entry of a single Korean Multinational in garment exports led to the establishment of a number of domestic export firms, creating the country’s largest export industry.
The study by Chen, Chang and Zhang (1995), using time series data for the period of 1979-93, estimated the regression between GNP, domestic saving in one period lag, and FDI in one period lag (all in logarithmic value). The results of the study show that there is a positive relationship between FDI and GNP and it is significant at 5 per cent level for the Chinese economy.
Bashir (1999) examined the relationship between FDI and growth empirically in some MENA countries, using panel data. The study found that FDI leads to economic growth; the effect however varies across regions and over time

Recent Issues Related To FDI in India:

- Union Budget 2012-13: Efforts on for consensus on 51% FDI in multi-brand retail. (March 16, 2012, TIMES OF INDIA)
- FDI down 33% in Dec to $1.35 bn (March 1, 2012, TIMES OF INDIA)
- Govt justifies 26% FDI cap in print media (December 21, 2011, TIMES OF INDIA)
- FDI inflows up 36% in Jan-Oct (January 2, 2012, TIMES OF INDIA)
- FDI jumps 60% to $1.74bn in November (December 24, 2009, TIMES OF INDIA)
- Govt puts off FDI in banking (April 24, 2003, TIMES OF INDIA).

India’s retail industry is estimated to be worth approximately US$411.28 billion and is still growing, expected to reach US$804.06 billion in 2015. As part of the economic liberalization process set in place by the Industrial Policy of 1991, the Indian government has opened the retail sector to FDI slowly through a series of steps:
1995. World trade organization’s general agreement on trade in services, which includes both wholesale and retailing services, came into effect.

1997. FDI in cash and carry (wholesale) with 100 present rights allowed under the government approval route.

2000. FDI in cash and carry (wholesale) brought under the automatic route. Up to 51% in single brand retail outlet permitted, subject to press note-3 (2006 series).

2011. 100% FDI in single brand retail permitted.

The Key Decision Taken By Cabinet (Business Standard, 5 October 2012):

- **Insurance law amendment bill**
  
  To raise the FDI cap in private insurance to 49% from the existing 26%.

- **Pension fund regulatory and development authority bill**
  
  To give statutory powers to the interim pension regulator and open the sector to FDI

- **Forward contracts (regulation) amendment bill**
  
  To introduce more commodity futures, give more power to forward market commission,

- **Amendment to companies bill, 2011**
  
  To make spending on corporate social responsibility a mandatory provision for companies above a threshed.

Hypotheses:

The study has been taken up for the period 1991 – 2011 with the following hypotheses:

- Flow of FDI shows a positive trend over the period 1991 – 2011.
- FDI has a positive impact on economic growth of the country.

Data Collection:

The study is based on secondary data. The required data has been collected from various sources i.e. World Investment Reports, Asian Development Bank’s Reports, Various Bulletins Of Reserve Bank Of India, Publications from Ministry Of Commerce, Govt. Of India that are
available on internet. It is a time series data and relevant data have been collected for the period of 1991 – 2011.

The study is limited to a sample of investing countries e.g. Mauritius, Singapore, USA etc. And sectors like service sector, computer hardware and software, telecommunication etc. Which had attracted larger inflow of FDI from different countries.

**Importance of the Study:**

The study attempts to analyze the important dimensions of FDI in India. The study works out on the pattern and trends of the main determinants and dimensions of investment flow in India. The study also examines the role of FDI on economic growth in India for the period 1991 – 2011. The period of study is important because:

- July, 1991, India opened is doors to private sector and liberalized it economy.
- Experience of South – East Asian countries by liberalizing their economies in 1980s became stars of the economic growth and development in 1990s
- India experience with its first generation economic reform and the country’s economic growth and performance were considered safe heavens for FDI which led to second generation of economic reform in India in first decade of century.
- There is a considerable change in the attitude of both developing and developed countries towards FDI. They both considered FDI as most suitable form of external finance
- Increase in competition for FDI inflows particularly among developing nations.
- Current issues related to FDI in Retail sector (Multi brand retail)

**Analysis and Findings:**

Government of India has decided to allow 26% FDI and 23% FII investment in commodity exchange, subject to the provision that no single entity will hold more than 5% stake.

- Although India’s share in global FDI has increased considerably, but the pace of FDI inflows has been slower than China, Singapore, Brazil and Russia
- Due to continued economic liberalization since 1991, India has seen a decade of 7 plus percent of economic growth. In fact, India’s economy has been growing more than 9
percent for three consecutive years since 2007 which make country make a proficient performer among global economies

- At present India is the 4th largest and 2nd fastest growing economy in the world. It is the 11th largest economy in terms of industrial output and has the 3rd largest pool of scientific and technical manpower.
- There has been a generous flow of FDI in India since 1991 and its overall direction also remained the same over the years irrespective of the ruling party.
- India has considerably decreased its fiscal deficit from 4.3% in 2002-03 to 2.7% in 2007-08 and 1.15 in year 2009-11.
- FDI plays a crucial role in enhancing the economic growth and development of the country. Moreover, FDI as a strategic component of investment is needed by India for achieving the objectives of its second generation of economic reforms and maintaining the pace of growth and development of the economy.

### Major sources of FDI in India

<table>
<thead>
<tr>
<th>Mauritius</th>
<th>US</th>
<th>Singapore</th>
<th>U.K</th>
<th>Netherlands</th>
<th>Japan</th>
<th>Germany</th>
<th>Cyprus</th>
<th>France</th>
<th>Switzerland</th>
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<tr>
<td>39.9</td>
<td>8.8</td>
<td>7.2</td>
<td>6.1</td>
<td>4.1</td>
<td>3.4</td>
<td>2.9</td>
<td>2.1</td>
<td>1.5</td>
<td>1.1</td>
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Sources: compiled & commuted from the various issues of economic survey, RBI Bulletin, Ministry of commerce

### FDI Inflows in India – Sectoral Analysis of Top 10 Sectors (Rupees in Crores):

<table>
<thead>
<tr>
<th>Sectors</th>
<th>2007-8 (April-march)</th>
<th>2008-9 (April-march)</th>
<th>2009-10 (April-march)</th>
<th>2010-11 (For april, 10)</th>
<th>Cumulative inflows (april, 00-10)</th>
<th>% to total inflows in terms of USS</th>
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Services sector (financial & non financial)

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<tbody>
<tr>
<td>Computer software &amp; hardware</td>
<td>5623</td>
<td>7329</td>
<td>4350</td>
<td>765</td>
<td>44611</td>
<td>9%</td>
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<td>Telecommunications</td>
<td>5103</td>
<td>11727</td>
<td>12338</td>
<td>1914</td>
<td>42620</td>
<td>8%</td>
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<td>Housing &amp; real estate</td>
<td>8749</td>
<td>12621</td>
<td>13586</td>
<td>246</td>
<td>37615</td>
<td>7%</td>
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<tr>
<td>Construction activity</td>
<td>6989</td>
<td>8792</td>
<td>13544</td>
<td>345</td>
<td>36066</td>
<td>%</td>
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<td>Power</td>
<td>3875</td>
<td>4382</td>
<td>6908</td>
<td>547</td>
<td>21466</td>
<td>4%</td>
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<td>Automobile industry</td>
<td>2697</td>
<td>5212</td>
<td>5609</td>
<td>187</td>
<td>20860</td>
<td>4%</td>
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<tr>
<td>Metallurgical industry</td>
<td>4686</td>
<td>4157</td>
<td>1935</td>
<td>404</td>
<td>13845</td>
<td>3%</td>
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<tr>
<td>Petroleum &amp; natural gas</td>
<td>5729</td>
<td>1931</td>
<td>1328</td>
<td>522</td>
<td>12026</td>
<td>2%</td>
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<tr>
<td>Chemicals</td>
<td>920</td>
<td>3437</td>
<td>1707</td>
<td>115</td>
<td>11390</td>
<td>2%</td>
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(Sources- government of india-2009, ministry of finance, FDI Statistics, department of industry policy & formation)

**Ranking Of Sector Wise FDI Inflows in India since April 2000- Dec 2011:**

**Rank of Sector–wise FDI Inflows**

<table>
<thead>
<tr>
<th>Industrial sectors</th>
<th>Rank</th>
</tr>
</thead>
<tbody>
<tr>
<td>Service sector</td>
<td>1</td>
</tr>
<tr>
<td>Computer hardware &amp; software</td>
<td>2</td>
</tr>
<tr>
<td>Telecommunication</td>
<td>3</td>
</tr>
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</table>
Conclusion:

This may be due to the low flow of FDI into India both at the macro level as well as at the sartorial level. It implies that the spirit in which the economy has been liberalized and exposed to the world economy at the late eighties and early nineties has not been achieved after so many years. This calls for a judicious policy decision towards FDI at the sartorial level. A large number of changes that were introduced in the country’s regulatory economic policies heralded the liberalization era of the FDI policy regime in India and brought about a structural breakthrough in the volume of the FDI inflows into the economy maintained a fluctuating and unsteady trend during the study period. It might be interest to note that more than 50 per cent of the total FDI inflows received in India come from Mauritius, Singapore and the USA. The main reason for higher levels of investment from Mauritius was that the fact that India entered into a double taxation avoidance agreement (DTAA) with Mauritius were protected from taxation in India. Among the different sectors, the service sector had received the larger proportion followed by computer software and hardware sector and then telecommunication sector.

References:


