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## FOREIGN DIRECT INVESTMENT IN INDIA - TRENDS, PATTERN AND LINKAGE

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### **Abstract**

*Foreign Direct Investment (FDI) plays an important role in the growth process of a country. There are two types of FDI: Inward Foreign Direct Investment (IFDI) and Outward Foreign Direct Investment (OFDI). We analyze the trends and pattern of FDI in India in this paper. To examine the structure of IFDI in India in the past 23 years (1990 -2012), data were collected from various published sources. The trend in India's Foreign Direct Investment, after the economic reforms, was assessed to analyze the impact of IFDI on the economic growth of the country in terms of GDP. The study confirmed that GDP, OFDI and Export have positive significant effects on IFDI in India. On the other hand, the import was not significant in determining the IFDI in the country. It is found that developing nations like India are able to attract IFDI on par with the developed countries while their overseas investment (FDI outflow) is far lesser than the developed countries.*

**Keywords:** *Foreign Direct Investment, Economic Growth, Export, Import, GDP.*

**JEL CODE:** E22, F43, O47

### **1. Introduction**

Foreign Direct Investment (FDI) plays an important role in the development process of a country. FDI is generally defined as “a form of long term international capital movement, made for the purpose of productive activity and accompanied by the intention of managerial control or participation in the management of

foreign firm.” It has potential for making contribution to the development through the transfer of financial resources, technology and innovative and improved management techniques, along with raising the productivity. (Chaturvedi, 2011)

According to Investopedia, FDI is the investment made abroad, usually where the company being invested in is controlled by the foreign corporation. FDI is a measure of foreign

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ownership of productive assets such as factories, mines and land. Increasing foreign investment can be used as a measure of growing economic globalization.

Foreign Direct 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.

The various forms of FDI are direct foreign investment, foreign collaboration, inter-government loans, loans from international institutions, and External commercial borrowing. A foreign direct investor may be classified as an individual, a group of related individuals, an incorporated or unincorporated entity, a public or private company, a group of related enterprises, a government body, an estate (law), trust or other social institution or any combination of the above.

## 2. Review of Literature

In an empirical analysis by **Alfaro Laura (April 2003)**, in an article “Foreign Direct Investment and Growth: Does the Sector Matter?”, using cross-country data for the period 1981-1999, suggests that total FDI exerts an ambiguous effect on growth. Foreign direct investments in the primary sector, however, tend to have a negative effect on growth while investment in manufacturing a positive one. Evidence from the service sector is ambiguous.

**Moreira (2008)**, in an article, “The Determinants of Foreign Direct Investment What is the Evidence for Africa?”, shows that FDI in African countries was largely driven by their natural resources or aimed at the local market and these were not the only determinants of FDI to the region. Even though the African countries that had been able to attract most FDI, had been those with natural and mineral resources as well as large domestic markets, many other factors also influenced investment decisions in Africa.

**Nuti (2009)**, in the article, “The Impact of the Global Crisis on Transition Economies”, examined an unexpected, profound and long-drawn-out recession which characterized the post socialist transition of Central-Eastern Europe and the former Soviet Union in the 1990s, with GNP decline ranging from 18 per cent over three years in Poland, to 65 per cent over ten years in Moldova. The decline may be slightly blown up especially at the top of the range, for well known reasons. But a reliable and unbiased observer, Bob Mundell, reckons that the transition recession was not only deeper than the 1929 crisis but also deeper than the recession that accompanied the Black Death in the 14th century because then income fall was matched by population fall and living standards were preserved.

**Williams (2009)**, in the article, Determinants of Outward Foreign Direct Investments from Small Island Developing States”, asserts that there was no doubt governments wanted to improve the standard of living of citizens and the promotion of outward FDI could be a useful tool to help achieve the goal. He suggested that if per capita income at home increases, the level of outward direct investment will decrease. The idea may be that with consumers in the home market getting richer, then there is no need to go abroad. The

firm could exploit its advantages at home and still remain profitable.

**Aboudou (2010)**, in the article, “The effects of foreign direct investment on economic growth: evidence for Togo” used the data running over 33 years from 1975 to 2008. Generally, the results obtained by using the Ordinary Least Squares (OLS) methods, demonstrate that FDI, Trade volume, and Human capital have a positive impact on economic growth. There was some evidence that inflation and Government consumption generated a negative impact on economic growth. The empirical analysis shows that FDI by itself plays an unclear role in the contribution to economic growth and he concluded that FDI could play an important role in the development efforts of the region.

**Duan (2010)**, in the article, “FDI in BRICs: A Sector Level Analysis”, compares the overall trends and industrial patterns of inward FDI in the BRICs and explains their determinants. The overall trend of the inward FDI in the BRICs was increasing. Nevertheless, the industrial patterns of inward FDI were different from each other. In Brazil, Russia and India, the tertiary sector received the most inward FDI on an average over the past decade while the primary sector received the least and the secondary sector was in the middle. But China had a special industrial pattern of inward FDI in which the secondary sector was dominant and the primary and tertiary sectors received only a bit.

**Gorynia, Nowak, Wolniak (2010)**, in the article, “Foreign Direct Investment Of Central And Eastern European Countries, And The Investment Development Path Revisited”, examined evidence provided by the analysis of the OFDIPI (Outward Foreign Direct Investment Performance Index) and confirmed

that the countries under study weathered, with different strength and success, the negative consequences brought about by the last global recession. Only a minority of the CEE-10 (Central and Eastern Europe) countries were able to improve its OFDIPI values. This, of course, brings into focus the necessity of all the remaining countries in the group to institute economic policy measures addressed to the solution and to get rid of the existing unfavorable situation.

**Deseatnicov, Hiroya (2011)**, in the article, “Effects of Political Risks on Japanese Outward Foreign Direct Investments: A Panel Data Analysis”, concluded that Japanese FDI could be reasonably explained by the proposed independent variables. According to the results, the most probable form of Japanese FDI was horizontal and platform type FDI on an average. They successfully found that political risk, with interaction with national culture and technological indices, was expected and significantly associated with Japanese FDI flows and those determinants should be taken into consideration in the future research on Japanese FDI.

**Khazri, Djelassi (2011)**, in the article, “The Relationship Between Financial Liberalization, FDI and Economic Growth: An Empirical Test For MENA Countries”, analyzed empirically the relation between financial liberalization (FDI) and economic growth in MENA (Middle East and North Africa) countries. On the basis of data related to six MENA countries observed over the period 1986-2010, it was evident that there was negative relation between financial liberalization and economic growth and a positive and significant association between FDI and GDP. The level of FDI leads to more value and to less unemployment and increased the level of economic growth.

Table 1 gives a clear picture on various advantages and disadvantages of FDI on host and home country. FDI supports the economy to grow at a faster rate, along with certain disadvantages to the society. FDI has been one of the most influential forces in boosting the growth rate of the Indian Economy since 1990s.

### 3. Research Objectives

The research objectives can be classified as follows.

- i. This paper attempts to assess the trend in India's Foreign Direct Investment after the economic reforms and to analyze the impact of FDI on the economic growth of the country in terms of GDP.
- ii. This paper seeks to provide an overview on the global scenario of FDI inflow and outflow, followed by trend in India's FDI with the major challenges and opportunities to attract more FDI in future.
- iii. We propose to examine the linkage between Outward FDI, Inward FDI, GDP and Exports and Imports

To examine the trends in FDI during the last 23 years (1990-2012), secondary data were collected from various published sources like Central Intelligence Agency Database, UNCTAD, world investment and RBI reports.

### 4. Research Gap

A large number of researches have been done on Foreign Direct Investment in India but almost all of them have been conducted on short term movement of IFDI, OFDI, GDP, Export and Import. Hence it is important to analyze the long term relation between these variables. The study proposes to analyze the FDI by using data for the last 23 years (1990-2012), which will help in filling the gap that exists due to the lack of any study on the above mentioned

subject. The correlation and regression analyses were carried out to analyze relationship between the variables.

### 5. Hypotheses

- ❖ H1. There is a relationship between IFDI and GDP.
- ❖ H2. There is a relationship between IFDI and OFDI.
- ❖ H3. There is a relationship between IFDI and EXPORT.
- ❖ H4. There is a relationship between IFDI and IMPORT.

### 6. Foreign Direct Investment: Global Scenario

According to CIA World Fact Book 2012, the top ten countries, on the basis of FDI stock, are listed. US ranked first, followed by France, UK. Canada is ranked 10<sup>th</sup> in the world. Charts-1 and 2 display the trends in FDI of the world. It describes the trend in FDI inflow in developed and developing countries for the past 20 years. In 2001, the value of inflow as well as outflow curve recorded a dip due to the 9/11 attacks. World FDI inflow came down from US \$ 1402 Billion in 2000 to US \$ 826 Billion in 2001. It started growing from 2003 and in 2007, it achieved the highest value. But it declined after 2007 due to the US credit crisis of 2008.

The Chart-2 describes the trend in world FDI outflow. World FDI outflow declined from US \$ 1232 Billion in 2000 to US \$ 752 Million in 2001 and started increasing later. Even though the crisis took place in US, it had ripple effect on other major economies of the world. The developing economies did not experience deeper effects compared to developed countries. When we compare the asian countries with the developing nations, it recorded lesser impact during the crisis and the revival started

immediately. Global FDI flows had declined in 2012 by 14% from 2011. In 2012, 44% of global FDI inflows were hosted by only five countries (China, US, Brazil, UK and France). There is a wide gap between developed and developing countries in FDI outflow than the inflow. It means that developing countries are able to attract FDI on par with the developed countries while their overseas investment (outflow) is far lesser than the developed countries.

## **7. Trends in India's Foreign Direct Investment**

A number of measures have been undertaken to make India a more attractive destination for FDI. Some key measures include allowing FDI in new sectors, dispensing with the need for multiple approvals from Government and/or regulatory agencies that exist in certain sectors and extending the automatic route to more sectors.

Starting from a baseline 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, US and UK were among the leading sources of FDI. India's recently liberalized FDI policy (2005) allows upto 100% FDI stake in ventures. Industrial policy reforms have substantially reduced industrial licensing requirements, removed restrictions on expansion and facilitated easy access to foreign technology and foreign direct investment. FDI is permitted in India only through financial collaborations, joint ventures and technical collaborations, capital markets via Euro issues, and private placements or preferential allotments. Foreign direct investments in India are approved through two

routes, namely, Automatic Approval by RBI and the FIPB Route – processing of non-automatic approval cases.

### **(a) Automatic Approval by RBI**

The Reserve Bank of India accords automatic approval within a period of two weeks (subject to compliance of norms) to all proposals and permits foreign equity upto 24%; 50%; 51%; 74% and 100% depending on the category of industries. The lists are comprehensive and cover most industries of interest to foreign companies. Investments in high-priority industries or for trading companies primarily engaged in exporting are given almost automatic approval by the RBI.

### **(b) The FIPB Route – processing of non-automatic approval cases**

FIPB stands for Foreign Investment Promotion Board which approves all other cases where the parameters of automatic approval are not met. Normal processing time is 4 to 6 weeks. Its approach is liberal for all sectors and all types of proposals and rejections are few. It is not necessary for foreign investors to have a local partner, even when the foreign investor wishes to hold less than the entire equity of the company. The portion of the equity not proposed to be held by the foreign investor, can be offered to the public.

Sector wise analysis of FDI Inflow in India, reveals that maximum FDI has taken place in the service sector, including the telecommunication, information technology, travel and many others. The service sector is followed by the computer hardware and software. High volumes of FDI take place in real estate, construction, power and automobiles also.

It has been found from several studies that a strong relationship exists between FDI

flows and financial sector reforms rather than from privatization and liberalization. Investors highly prefer host countries with financial system that is able to allocate capital efficiently, monitor firms, diversify and share risk and ultimately mobilize savings. Financial reform is a precondition for maximization of the benefits of spillovers to foreign investors. Foreign investors are attracted to countries with more stable macro-economic environment, higher levels of economic development and better infrastructure. Apart from underlying macro fundamentals, ability of a nation to attract foreign investment essentially depends upon its policy regime whether it promotes or restrains the foreign investment flows.

## 8. FDI Policy of India

There has been change in Indian FDI policies since early 1990s. Historically, India had adopted an extremely cautious, selective approach, with emphasis on import substitution strategy. After the enactment of FERA (Foreign Exchange Regulation Act), foreign equity holding in a joint venture was allowed only up to 40%. SEZs offered various types of incentives to promote exports of the country. The announcements of Industrial Policy (1980-1982) and Technology Policy (1983) adopted liberal attitude towards foreign investment.

### Post liberalization

- i) Introduction of dual route of approval of FDI: RBIs automatic route and government approval (SIA/FIPB) route.
- ii) Automatic permission for technology agreements in high priority industries and removal of restriction of FDI in low technology areas.
- iii) Permission to NRIs and OCBs to invest up to 100% in high priorities sector.

- iv) Signing the convention of Multilateral Investment Guarantee Agency (MIGA) for protection of foreign investors.
- v) FEMA replaced FERA, which is less stringent.
- vi) The Portfolio Investment Scheme (PIS) allows NRIs/PIOs to invest in shares of listed companies in recognized stock exchange.
- vii) Under Non Resident Rupee Account Scheme, NRIs are eligible to open NRE accounts with any authorized bank in India.

The Government has relaxed FDI regime in sectors, including multi brand retail, single brand retail and 49% in aviation sector. FDI capital increased from 49% to 74% in broadcasting and ARCs. Foreign investment has also been allowed in power exchanges. FII investors are allowed to invest upto 23% in commodity exchanges, without seeking prior approval from Government. Power tariff incentives are extended by state governments in different ways, such as exemption from payment of electricity duty and freeze on tariff charged for new units for a few years. Export Processing Zones, Special Economic Zones, Electronic Hardware Technology Parks, Software Technology Parks would qualify for automatic route. The equity holding in Small Scale Industries were permitted upto 24%. The above mentioned policy changes had created more opportunities to the country to allow and attract FDI to grow at faster rate.

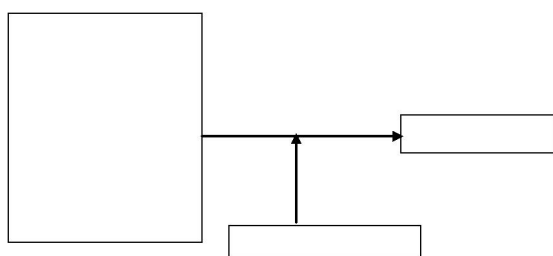
It is well known that FDI can complement economic growth efforts in a number of ways, including boosting export competitiveness, generating employment and strengthening the skills base, enhancing technological capabilities (transfer, diffusion and

generation of technology) and increasing financial resources for development. It can also promote a more competitive business environment.

The GDP is very important for any country for foreign investor to make decisions for investment. Fundamentally, economic conditions are expected to exert influence on IFDI. Gross and Trevino (1996) highlighted that countries possessing a higher GDP growth rate are expected to promote a large quantity of FDI. High economic growth rates are likely to attract investors in finding the market potential for higher return values on investments which are confined to higher levels of FDI (Biglaiser & DeRouen, 2011). On this count, the following hypothesis was proposed to be empirically investigated.

### 9. Research Framework and Variable Measurements

For determining the course of empirical investigation, the following research framework was devised to trace the impact of various types of select variables on FDI in India during 1990-2012.



The following variables were included in the empirical investigation process of the study.

IFDI = Inflows of Foreign Direct Investment.

OFDI = Outflows of Foreign Direct Investment.

GDP = Gross Domestic Production.

Exports = Total Exports of the country.

Imports = Total Imports of the country.

### 10. Data Analysis and Results

To investigate the effects of economic variables on the IFDI in India, this study followed the following steps.

The process of economic growth is a complicated issue. This is because many variables can be used to explain economic growth. However, the link between FDI and economic growth is derived from what IFDI provides to the economy as a whole. For instance, the most obvious effect of IFDI on the growth potential of India may be the provision of additional capital. Table 3 presents the Correlation Matrix of the data of study and it is seen that all variables are positively correlated with the IFDI.

This result is a preliminary evidence of the link between the IFDI and other variables. The coefficient of correlation is 0.89 between IFDI and GDP; 0.87 between IFDI and OFDI; 0.90 between IFDI and EXPORT; 0.88 between IFDI and IMPORT. It means that there is high degree of positive correlation between IFDI and Economic Growth of the country.

### 11. Regression Analysis Results

After the regression assumptions were checked and found to be satisfied, it was used to identify and compare the predictive power of the dimensions of economic variables, namely, GDP, OFDI, Exports and Imports. Based on the results in Table 4, it can be concluded that GDP ( $\beta=1.832$ ,  $t=2.218$ ,  $p<0.05$ ), OFDI ( $\beta=0.122$ ,  $t=0.306$ ,  $p<0.05$ ) and Exports ( $\beta=0.740$ ,  $t=3.698$ ,  $p<0.05$ ) have significant positive impact on the IFDI at 0.05 levels of significance. In addition, the results reveal that GDP, Exports and Imports



had greater impact on the IFDI in India. These results, however, supported the hypotheses H1, H2 and H3. Import was not a significant determinant of the IFDI in the case of India.

The empirical findings of this study are based on the analysis pertaining to 23 year period of data from 1990 to 2012 relating to IFDI in India. To test the hypotheses of this study, linear regression was employed. The results of the study imply that some of the hypotheses are supported. In particular, the hypotheses H1, H2 and H3 are supported with IFDI in India, whereas H4 is not supported.

## 12. Conclusion

The present study concludes that IFDI records a positive correlation between other economic variables and many hypotheses are supported. The analysis of structure of FDI in India reveals that after liberalization, there has been a shift in favor of service sector and a steep fall in the share of manufacturing sector. However, this trend matches the structure of FDI inflows to the developing countries and even the world. It can be observed from the above analysis that at the sectoral level of the Indian Economy, FDI has helped to raise the output, productivity and employment in some sectors, especially in the service sector.

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**Reports:**

World development report 2012











CMIE report 2012

RBI report 2012

**Table-1: Advantages and Disadvantages of Foreign Direct Investment**

To host country	
○ Availability of scarce factors of production	○ Strained balance of payment following reverse flow
○ Improvement in the balance of payments	○ Dependence on the import of technology
○ Building of economic and social infrastructure	○ Employment of expatriates
○ Fostering of economic linkages	○ Inappropriate technology
○ Strengthening of the government budget.	○ Unhealthy competition
	○ Cultural and political interference
To home country	
○ Availability of raw material	○ Undesired outflow of factors of production
○ Improvement in balance of payments	○ Possibility of conflict with the host country government
○ Employment generation	
○ Revenue to the government	
○ Improved political relations	

**Table-2: List of Top Ten countries based on FDI stock**

Rank	Name of the country	FDI stock at home (US \$ Billions)
1	 United States	2,581
2	 France	1,207
3	 United Kingdom	1,169
4	 Germany	1,057
5	 Hong Kong SAR	962.2
6	 Belgium	741.7
7	 Netherlands	687.8
8	 Spain	668.5
9	 China	574.3
10	 Canada	528.7

Source: [http://en.wikipedia.org/wiki/List\\_of\\_countries\\_by\\_received\\_FDI](http://en.wikipedia.org/wiki/List_of_countries_by_received_FDI)

**Table-3** Correlation matrix

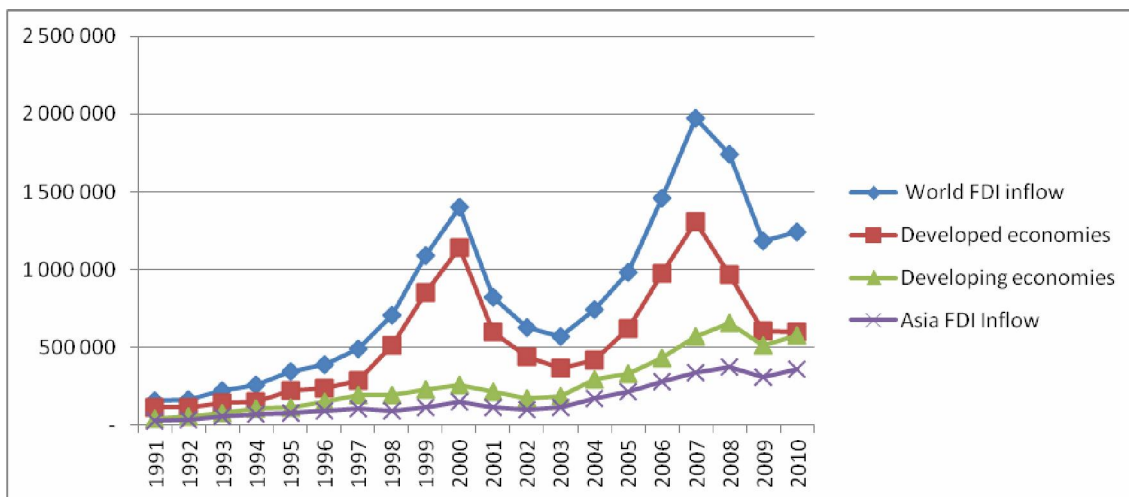
Variables	IFDI	GDP	OFDI	EXPORT	IMPORT
IFDI	1	.89	.87	.90	.88
GDP		1	.98	.88	.99
OFDI			1	.86	.98
EXPORT				1	.90
IMPORT					1

**Table-4** Examining variables predictive power

Variables	Beta	T value
GDP	1.832	2.218
OFDI	0.122	0.306
EXPORT	0.740	3.698
IMPORT	-1.727	-2.049

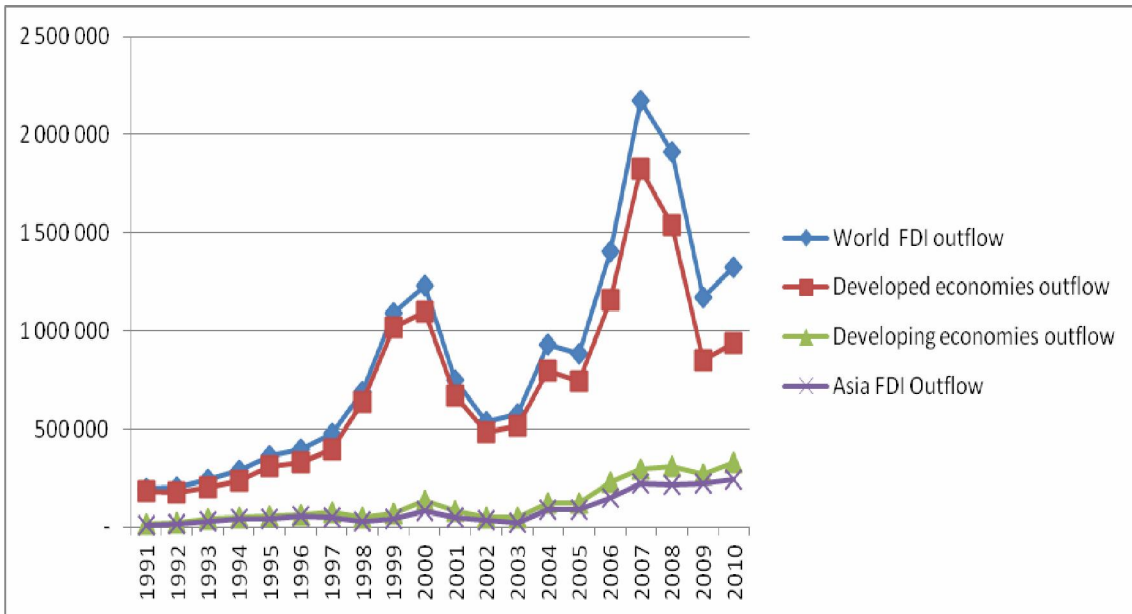
\*\*\*:  $p < 0.01$ ; \*\*:  $p < 0.05$

**Chart-1 : Trend in FDI inflow of Developing and Developed countries**



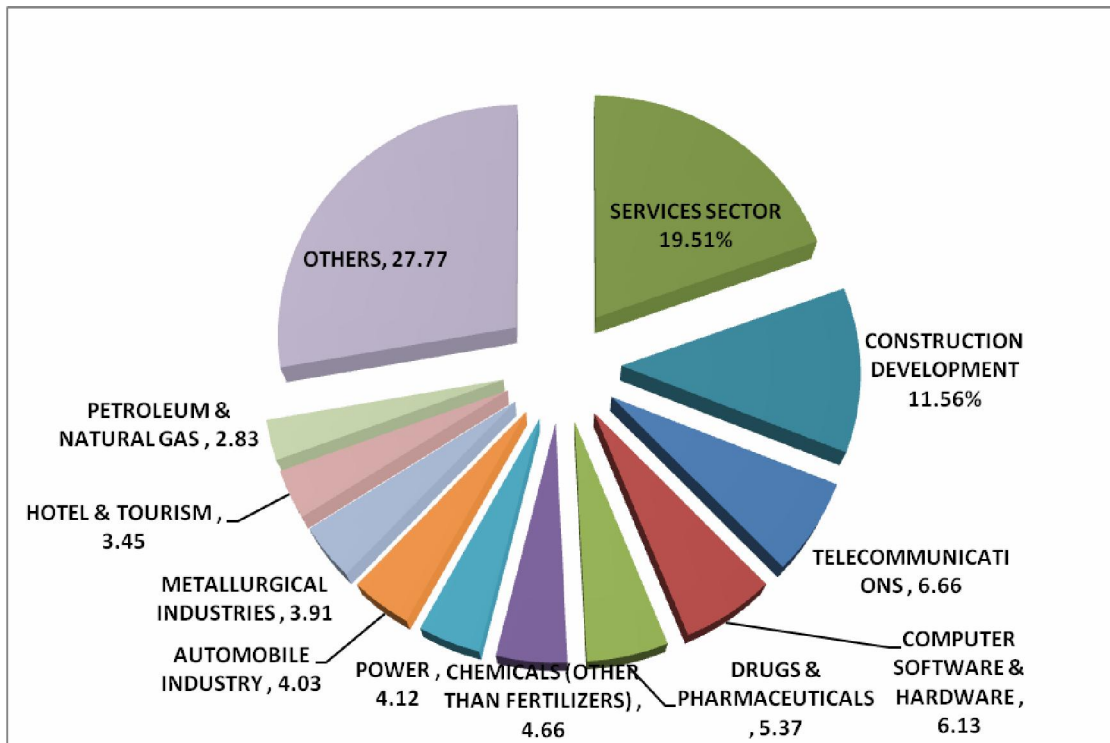
Source: International Trade Centre

**Chart-2: Trend in FDI outflow of Developing and Developed countries**



Source: International Trade Centre

**Chart-3: Sector wise – classification of India’s FDI**



Source: International Trade Centre