FDI and Its Impact on Indian Economy

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Abstract - The present study attempts to empirically examine the impact of Foreign Direct Investment (FDI) equity inflows on Indian economy over the period of April 2005 to March 2011, before and after the eruption of Global Financial Crisis. The study explains the linkages between FDI equity inflows and macro-economic variables such as Inflation, Index of Industrial Production (IIP), interest rates, exchange rates and foreign exchange reserves. The empirical results indicate that GDP, inflation and Trade Openness are important factors in attracting FDI inflows in India during post-reform period whereas Foreign Exchange Reserves are not important factors in explaining FDI inflows in India.

Keywords: Foreign Direct Investment, Equity Inflows, Foreign Exchange Reserves

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1. INTRODUCTION

Foreign Direct Investment (FDI) plays a pivotal role in the process of economic development particularly in the capital scarce country, where the domestic base of created assets like technology, skills and entrepreneurship are quite limited. It provides financial resources for investment in a host country and thereby augments domestic saving efforts. It also plays an important role in accelerating the pace of economic growth. FDI provides the much needed foreign exchange to help the bridge the balance of payment or trade deficit. FDI brings complementary assets such as technology, management and organizational competencies and there are spillover effects of these assets on the rest of the economy. FDI is treated as a main engine of economic growth and technological development which provides ample opportunities in accelerating economic development.

Foreign investment flows, broadly, can be classified into i) FDI and ii) Portfolio Investment from Foreign Institutional Investors (FII). FDI means investment made by a non-resident/entity in the capital of an Indian company under schedule 1 of Foreign Exchange Management Regulations 2000. Dunning (1993) states that FDI, when compared to portfolio investment, involves the transfer of resources other than capital viz., technology, management, organisational and marketing skills etc. from a foreign country to the host country. It is the expected return on these resources, rather than on the capital per se, which prompts firms to become Multi-National Corporations. Further, in case of FDI, resources are transferred internally within the firm rather than externally between two independent parties; de jure control is still retained over their usage. This however, is not the case in respect of portfolio investment.

Foreign investment was introduced in 1991 under Foreign Exchange Management Act (FEMA), driven by then finance minister Manmohan Singh. As Singh subsequently became a prime minister, this has been one of his top political problems, even in the current (2012) election. India disallowed overseas corporate bodies (OCB) to invest in India. It is observed that FDI rose swiftly form 2006-07 onwards, as India allowed 100% FDI through automatic route. Extensive research has been conducted throughout the world on 'Foreign Investment Flows' for the last two decades. Many of the studies focused on the determinants of FDI and very few scholars studied the impact of FDI on the host economy. In India, research studies in this area are rather limited. In view of the above, the objective of the present study is to study is to study the *impact of FDI on Indian economy* since April 2005 i.e., after which FDI has been growing rapidly in India. Further, the study also delineated the trends and progress of FDI inflows into India before and after the eruption of Global Financial Crisis.

The present study has been divided into six sections. The second section deals with the Survey of Literature. The third section narrates the research methodology of the study. The fourth section delineated the trends and progress in FDI across the world as well as in India. The impact of FDI inflows on India with a theoretical perspective is discussed in the fifth section. The main conclusions emerging out of the study are presented in sixth section.

2. LITERATURE REVIEW:

Many empirical studies have been undertaken to analyze the impact of Foreign Direct Investment (FDI) on India, few of them are as follows:-

Montiel and Reinhart (1999) found that a combination of push and pull factors affect capital flows; while the push factors can explain the timing and magnitudes of foreign investments, the pull factors determine the geographic distribution of the flows amongst the recipient economies.

Mucchielli and Soubaya (2000) investigated the determinants of the volume of trade of the French Multinational Corporations (MNCs). The major findings suggest that inward FDI has a positive influence on Foreign trade (including exports and imports), and this positive influence is stronger for exports compared with imports.

Charkraborty and Basu (2002) explore the co-integration relationship between net inflows of FDI, real GDP, unit cost of labor and the proportion of import duties in tax revenue for India with the method developed by Johansen (1990). They find two long-run equilibrium relationships. The first relationship is between net inflow of FDI, real GDP and the proportion of import duties in tax revenue and the second is between real GDP and unit cost of labor. They find unidirectional Granger Causality from real GDP to net inflow of FDI.

Naga Raj (2003) discusses the trends in FDI in India in the 1990s and compares them with china. The study raises some issues on the effects of the recent investments on the domestic economy. Based on the analytical discussion and comparative experience, the study concludes by suggesting a realistic foreign investment policy.

Salisu A.A. fees (2004) examined the determinants and impact of FDI on economic growth in developing countries using Nigeria as a case study. The study observed that inflation, debt burden, and exchange rate significantly influence FDI inflows into Nigeria. The contribution of FDI to economic growth in Nigeria was very low even though it was perceived to be a significant factor influencing the level of economic growth in Nigeria

Nandita Dasgupta (2007) examined the effects of international trade and investment related macro-economic variables, namely, exports, imports and FDI inflows and the outflows of FDI from India over 1970 through 2005. Unidirectional Granger Causality was found from export and import to FDI outflows, but no such causality exists from FDI inflows to the corresponding outflows from India.

Burak Camurdan and Ismail Cevis (2009) developed an empirical framework to estimate the economic determinants of FDI inflows by employing a panel data set of 17 developing countries and transition economies for the period of 1989-2006. Seven independent variables were taken for this research namely, the previous period FDI, GDP growth rate, wage, trade rate, inflation rate and economic investment. The empirical results conclude that the previous period FDI is important as an economic determinant. Besides, it is also understood that the main determinants of FDI inflows are Inflation rate, the interest rate and trade (openness) rate.

Dua and Ranjan (2010) in their study on ‘Exchange rate Policy and Modeling in India’ explained that though capital flows are generally seen to be beneficial to an economy, a sudden surge in inflows over a short span of time in excess of the domestic absorptive capacity can, however, be a source of stress to the economy giving rise to upward pressures on the exchange rate, overheating of the economy and possible asset price bubbles. Further, foreign investment may have a negative impact on a country’s BoP due to repatriation of returns over a period of time, in the form of interest, dividends and royalties which, sometimes, exceed the foreign investment itself.

Dr. Y. V. Reddy, former governor of RBI endorses this view in his latest book on ‘Global Crisis: Recession and uneven recovery’, 2011 and confirms that can not be construed as permanent capital. FDI, at best, is less temporary. FDI in green-field projects may be treated as permanent source of foreign capital.

3. RESEARCH METHODOLOGY

An attempt has been made through the present study to understand the impact of FDI on Indian economy from April 2005 to March 2011 i.e., before and after the eruption of Global Financial Crisis. The components of FDI, as per Reserve Bank of India (RBI) classification are i) equity investment, ii) re-invested and iii) other capital (including inter-company debt transactions of the firms that received FDI).

While the RBI follows the above classification in respect of FDI flows, The Ministry of Commerce &

Industry (MoCI), Government of India shows only ‘equity investment inflows into India’ as FDI. In vies of the same, there exists a discrepancy in the data reported by these tow agencies. The present paper considers the data reported by Ministry of Commerce & Industry since equity investment flows represent actual FDI inflows into India (rather than reinvested earnings / inter-company debt transactions). Monthly data in respect of FDI equity inflows (FDI), Index of Industrial Production (IIP which is a proxy to Gross Domestic Product), Wholesale Price Index (WPI), Weighted average call money interest rates (INTR), Foreign exchange reserves (FR) and Average exchange rate of USD / INR (ER) are considered for the purpose of the study. The entire data have been sourced from RBI in respect of all variables except in case of FDI equity inflows, which have been obtained form MoCI. Correlation Coefficients Matrix has been used.

4. TRENDS & PROGRESS OF FDI INFLOWS

As per the World Investment Report, UNCTAD, 2011, the total volume of global FDI inflows steed at USD 1393 bn. in 2000 and peaked at USD 1971 bn. in 2007 before getting reduced to USD 1244 bn. In 2010 due to gloomier economic outlook, austerity measures, possible sovereign debt crisis and fiscal & financial sector imbalances in the developed economies coupled with rising inflation and signs of overheating in major EMEs etc. The report hints that cross-country FDI inflows into services sector declined in general and financial sector in particular, during 2010.

As India embarked on economic reforms in 1991 and liberalized her Capital Account gradually, the country experienced significant growth in FDI inflows during the last two decades reflecting the ‘India’s growth story’. Since 1991, FDI has been allowed into India under two routes viz., i) Automatic route and ii) Approval route with certain sectoral caps. Subsequently in 2000, all industries, except a few, for strategic reasons have been brought under Automatic route. India’s FDI equity inflows were at a low level of USD 167 mn. In 1991-92 which increased later to USD 5.5 bn. In 2005-06 and reached the peak level of USD 27.3 bn. in 2008-09 before declining to USD 19.4 bn. during 2010-11 owing to Global Economic Slowdown as sown below.

Table 1 – FDI equity inflows in India

(in USD Mn.)

Financial Year	FDI equity inflows
2005-06	5,559
2006-07	15,730
2007-08	24,579
2008-09	27,308
2009-10	25,888
2010-11	19,429
Total	**118,483**

Source: Ministry of Commerce & Industry, Government of India

It can be seen form the above table that FDI inflows rose swiftly during 2006-07, as India allowed 100% FDI through automatic route for a number of sectors such as Green-field airport projects, lying of pipelines, export trading etc. Besides, Government of India enhanced the FDI caps in Telecom and Aviation sectors which resulted in a sharp jump in FDI inflows into India since 2006-07. over a period of time, FDI in India has been allowed up to 100% in sectors viz., Mining, Chemicals, Pharmaceuticals, Power, Coffee and Alcohol, Greenfield airports, Courier services, investment companies for the purpose of infrastructure (except telecom), NBFCs and SEZs.

FDI inflows into India, however, declined in 2010-11 partly due to her macro-economic concerns such as rising fiscal deficit and corruption scandals etc. coupled with global economic uncertainties. As per the latest Transparency International’s survey, India is placed at 87th position in Corruption Index out of the total 181 countries surveyed. FDI equity inflows into India peaked during 2008-09 by reaching USD 27.3 bn. and later came down suddenly to USD 19.4 bn. in 2010-11 due to the Global Economic Slowdown. World Investment Report, UNCTAD, 2011 states that the volatility of the business environment after the crisis, particularly in developed countries, makes the foreign investors relatively cautious regarding their investments in EMEs.

Foreign investments in India are being routed through Mauritius are the highest followed by Singapore and Netherlands in 2010-11 (please refer Table II). The foreign investment inflows from the USA, Cyprus & Germany, however, declined significantly during the FY 2010-11 reflecting unwinding of overseas positions by investors due to heightened risk aversion and repatriation of the proceeds back home. Investors from Netherlands, the UK, France and Japan have been maintaining or increasing their investment exposure to India during 2010-11 despite the above concerns. The following table shows the trends and sources of FDI into India from various countries.

Table II – Country wise trends of FDI inflows into India

(in USD Mn.)

Source of FDI Country	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11
Mauritius	1363	3780	9518	10165	9801	5616
USA	346	706	950	1236	2212	1071
UK	261	1809	508	690	643	538
Germany	45	116	488	611	602	163
Netherlands	50	559	601	682	804	1417
Japan	86	80	457	266	971	1256
France	12	100	136	437	283	486
Singapore	166	582	2827	3360	2218	1540
Switzerland	68	57	192	135	96	133
South Korea	61	68	86	95	159	136
UAE	-	215	226	234	373	188
Cyprus	-	58	570	1211	1623	571
Others	900	1177	2866	3575	2676	1824
Total	**3358**	**9307**	**19425**	**22697**	**22461**	**14939**

Source: RBI

The above FDI inflows into India mostly channeled into sectors such as Manufacturing including engineering goods and chemicals; Construction and Real Estate, Power, Financial Services and IT & IT enabled Services over the years. The following table depicts the trends and uses of FDI in India sourced from the above mentioned countries.

Table III – Sector wise trends of FDI inflows into India

(in USD Mn.)

Sector	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11
Manufacturing	1405	1641	3726	4777	5143	4793
Construction	191	967	2551	2237	3516	1599
Financial Services	452	1330	3850	4430	2206	1353
Real Estate	-	431	1336	1886	2191	444
Power	83	174	829	669	1877	1338
Computer Services	770	824	1035	1647	866	843
Communication Services	-	423	66	2067	1852	1228
Business Services	-	2425	1158	643	1554	569
Restaurants & Hotels	95	153	280	343	671	218
Transport Services	66	165	816	401	220	344
Education, R & D	9	43	156	243	91	56
Misc. Services	110	298	1901	1458	888	509
Others	177	433	1721	1896	1386	1645
Total	**3358**	**9307**	**19425**	**22697**	**22461**	**14939**

Source: RBI

Note: the above data exclude FDI inflows under the NRI direct investment route through the RBI and inflows due to acquisition of shares under section 5 of FEMA 1999. The data, however, includes FDI through SIA / FIPB and RBI routes only.

While 'Manufacturing' sector garnered the lion's share in FDI inflows into India as evident from the above table, infrastructure segments such as power transportation, ports, airports, roads, railways, education facilities etc. also attracted major share of overseas investments. While FDI inflows have not led to an export-oriented manufacturing revolution in India, as happened in case of China, they have contributed in more subtle a 'global manufacturing hub' for certain products such as 'automobiles and auto components, telecom products and metal castings and emerged as a main contender to China in the overseas markets.

For the last one decade, India is considered as one of the major long-term investment destinations by the foreign investors because of her reform-oriented economy, macro-economic stability, gradual opening up of the Capital Account, investor friendly policy regime, lower costs of factors of production, increasing thrust on infrastructure Tax Treaties with certain countries such as Maritius, favourable interest rate and growth -differentials (with average GDP growth rate of ,7-8 % p.a.), largest English-speaking population that serve international BPO / KPOs, conductive time zone for the US and other advanced economies, substantial expertise in IT and ITES etc. The prospects for further foreign investments in India appear brigs as several policy initiatives are on the anvil.

5. FDI AND ITS IMPACT ON INDIA

When a country receives enormous amount of foreign investment inflows, a question arises as to sustainability of such flows if majority of them are of volatile or temporary in nature. Research indicates that FDI inflows, unlike portfolio flows from FIIS, are more permanent in character and have a positive impact on the real and financial sectors. All the variables are transformed to natural logarithm and correlation coefficients have been worked out to know the relationship between FDI and other macro-economic variables, as displayed in Table IV. It is found that there is a co-movement between FDI inflows and IIP, which supports the underlying theory – 'As more and more FDI flows into various sectors of the economy, there would be a spurt in manufacturing of goods and services across the country'. This would help in maintaining price stability in the economy, which can be seen from the negative correlation coefficient between IIP and WPI. Besides, it is observed that there is an indirect relationship between FDI and WPI s foreign investment flows are mainly meant for capital expenditure of firms that promote production of goods and services further and reduce the demand-supply gap, thereby restraining the inflationary pressures in the economy.

Variables	LDFDI	LDDIIP	LDER	LDFR	LDWPI	LINTR
LDFDI	1.00000					
LDDIIP	0.25819	1.00000				
LDER	-0.02950	0.15972	1.00000			
LDFR	0.15670	-0.04443	-0.45691	1.00000		
LDWPI	-0.05791	-0.29342	-0.10100	0.09083	1.00000	
LINTR	0.14862	0.08260	0.19522	-0.16328	-0.12346	1.00000

It is noticed that FDI and foreign exchange reserves have a positive correlation coefficient, in lime with the theory. It is also found that accumulation of foreign exchange reserves result in depreciation of USD against INR (negative correlation between FDI and exchange rate since USD is the base currency).

6. CONCLUSION

Foreign capital supplements and complements domestic capital to accelerate the pace of an economy's growth apart from offering benefits like transfer of technology, best international management practices, creation of new employment opportunities and costs such as increase in asset prices, appreciation of exchange rates thereby losing domestic export competitiveness which ultimately may lead to Current Account Deficit in the BoP.

The empirical study, conducted for the period from April 2005 to March 2011, revealed that FDI equity inflows accelerate the pace of industrial production in India and it will have a salutary effect on general price level in the economy. It is found that accumulation of precious foreign exchange reserves attract FDI inflows further. It is also found that FDI inflows do not affect the interest rates and exchange rates significantly. Hence, the Indian policy makers are encouraged to attract more and more FDI inflows into the country so as to accelerate the pace of industrial production thereby addressing supply side gaps to contain inflationary pressures in the economy and also to accumulate foreign exchange reserves so that international credit worthiness of the country can be enhanced.

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