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RESEARCH PAPER

Diagnosing the impact of foreign direct investment on the economic development of India

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ABSTRACT

Capital is the life blood of any production and distribution activity. And also capital can be a limiting factor for starting, expansion and diversification of a venture when in short supply. So, same is the importance of foreign capital for any country especially the developing countries. As a result of continuous efforts by the Govt. of India, there has been a steady rise in the inflow of foreign capital on one hand and overall progress in the various sectors of Indian economy as well. There has been tremendous progress in the various sectors of Indian economy due to the inflow of foreign capital. The GDP growth rate has crossed 9 per cent due the boom in manufacturing and service industries. Further the sensex points in stock market have crossed 21000 in Nov., 2010. Foreign, exchange reserves have also crossed $300bn. In addition there has been improvement in employment position ,standard of living, infrastructure development, health and hygiene. The present study examines and diagnoses the year wise, sector wise FDI inflows in India and observes analyses the impact of FDI on the growth of GDP, employment, inflation and stock market in India.

***Key words* :** Diagnosis, Impact, Foreign Direct Investment (FDI)

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Foreign Direct Investment (FDI) is defined as an investment made by an investor of the country to acquire an asset in another country with the intent to manage that asset, however the growth enhancing impact of FDI seems to vary from country to country depending upon the liberalization, their governance environment, resource availability etc. Developing countries are interested in attracting FDI because of perceived benefits in terms of injection of capital, technology and knowledge. India, today being considered as one of the important destinations of FDI has made efforts in post liberalization period to attract the maximum foreign capital. The impact of the foreign direct investment on Indian economy has been diagnosed in two facets – the micro effect *i.e.* the favourable environment from the investors point of view and macro effect on the major variables of economic growth.

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Two facets of foreign direct investment – Macro view and micro view:

Macro view sees FDI as the flow of capital across national borders from home countries to host countries measured in BOP statistics whereas the micro-view studies, the motivation for investment in controlled foreign operations from the viewpoint of investors. So, for diagnosing the impact of FDI on economic growth the motives for investing in a particular country have to be studied. These motives can be market availability, resource availability, efficient workforce, infrastructure, financial markets, governance factors of Govt. etc. These motives attract the individual or institutional investors towards a particular country affecting the economic growth which is further projected in the macro-view as the flow of capital across borders leading towards international business giving a spur to all the economies due to the competitive advantages of countries.

Positive outcomes of FDI:

International trade and investment:

Horizontal FDI *i.e.* investment in production facilities abroad that are designed to serve foreign customers and vertical FDI where different production stages take place in different locations thereby promoting exports and import substitution. Host country gets strengthened and integrates itself with the world economy.

Technology transfer:

FDI transfers the technology to host country either through MNE backward linkages or by mobility of labour. The big MNCs bring their latest technology to the host countries thereby improving the processes and production systems of the country.

Human capital enhancement:

Individuals employed by MNE subsidiaries enhance their skills by the job learning process and are thereby required to implement superior technologies at par with those prevalent in the developed nations.

Increased competition:

MNEs may assist in economic development by increasing domestic competition leading to higher productivity, lower prices, efficient utilization, quality products etc. however conversely it can hurt competition in the host country if the market is small.

Enterprise development:

FDI promotes the entrepreneurship development in the host country leading to capital formation by mobilizing the resources. When foreign companies bring their capital in the country and make huge benefits, it boosts up the entrepreneurial spirits of domestic investors also.

Knowledge spillover:

MNCs tend to orient their training more towards global markets. The human capital thus formed is of global standards. This developed human capital may move out of the MNC and join some domestic firm and putting their expertise there, this process is known as knowledge spillover.

Indian investment environment for FDI : Diagnosing the micro- view:

The Government of India has taken many initiative to attract FDI inflows, to boost the Indian economy since economic liberalization . Moreover there are other factors which are favourable for attracting FDI. Some of them are

– English proficiency and technical expertise has helped attracting the maximum FDI in service sector *i.e.* BPOs and consultancy services.
– Two phase programme for the presence of foreign banks through wholly owned subsidiaries has also helped in attracting the FDI by facilitating the payments mechanism.
– 100 per cent FDI is allowed under the automatic route for most of the sectors which has facilitated the investment in all the sectors of economy.
– IT sector is the most preferred sector for foreign investors because of the technical expertise availability in India.
– Application of Value Added Tax (VAT) *i.e.* uniform slab rate of 4 per cent and 12.5 per cent on the specific product list has minimized the taxation and legal formalities.
– Relaxation of repatriation norms for NRIs has also given a drive to invest in their home country.
– Indian economy is growing at a sustainable rate of 7-8 per cent which is a positive factor for luring the foreign investors.
– Indian market is one of the biggest markets of the world so the retail market of India has great potential.
– Power and telecom sectors are the major drivers of FDI because of the huge markets, resource availability and the infrastructural development.

Infusion of foreign capital reflects the provider country's confidence in the prospect of host country. So, the quality of the MNCs that enter the country matters. So, efficiency seeking FDI must be preferred over the rent seeking FDI. Although practically its not easy to distinguish between the two.

FDI Inflow : India vs China:

India and China are two emerging economic giants of the developing world with more than *% growth in their respective GDPs . Both the economies have immense natural resources, cheap but quality labour force, huge domestic market and above all the relatively stable political environment. Both the economies have vast potential to attract FDI to serve the local markets and to become a mor e important part of the global integration. After China's entry into world trade organization (WTO). China has emerged into the most attractive FDI destinationin the developing world. The UNACTAD (2005) and Asian Development Outlook (2005) highlight the fact that India's FDI is far below that of China and there is a wide gap between approvals and actual realization. Although prior to 1980s India received higher FDI than China but because of liberalization policy adopted by China in 1978, turned the tables in favour of China. The comparision of the two countries policies in attracting foreign investment gives a fair idea to indicate the reasons for the differences in FDI inflows and will enable us to suggest how India can improve its investment climate.

Reforms:

FDI regime in China is delineated in major investment laws and their implementing regulations. In addition, China has also offered number of incentives to attract since 1980's.India also gradually opened its economy since 1991 but due to the lack of political consensus Indian economy is still not free from bureaucratic controls.

Policy changes and initiatives:

Indian Government has regulated the inflow of FDI through a highly selective policy. It also gave the discretionary powers to FIPB to permit 100 per cent equity ownership in some cases, whereas China too grants preferential tax treatment to enterprises set up in SEZs. A crucial characteristic missing in Indian policy is the absence of tax exemption on imported materials and equipments also in some power projects, coal mining and petroleum refining projects.

Employment and infrastructure:

The Indian FDI policy scores over the policies of competing countries in the matter of employment of foreign personnel as restrictions on their employment does'nt exist in India. In terms of policy areas, simplification of entry routes raising of equity ceiling, introduction of a negative list, simplification of the operating systems IPR regulations are critical.

Growth rate and growing market:

With 37 per cent of the world's population, India and China are potentially the world's largest markets and the biggest host countries for FDI. India and China both believe that their economic tradeoff could only be achieved by attracting technology embodied foreign investment. Given their size and their level of development, China and India are apparently direct competitors for FDI.

FDI by non-resident Chinese and Indians (NRCs and NRIs):

Expatriate investment has a major share in China than in India. Such investments has been attracted by economies of scale and large market sizes. However, in China such investment has been oriented towards domestic market

Table 1 : FDI approvals and inflows in India (Amount USS$ million)

Sr. No.	Financial year (April-March)	Foreign direct investment: Equity: FIPB route/ RBI's automatic route/acquisition route	Equity: Equity capital of unincrop rated bodies#	Re invested earnings	Other capital +	FDI inflows: Total FDI inflows	FDI inflows: %age growth over previous year	Investment by FII's foreign institional investors fund (net)
(A)	1991-2000	15,483				15,483	-	-
(B)	2000-2009							
1.	2000-01	2,339	61	1,350	279	4,029	-	1,847
2.	2001-02	3,904	191	1,645	390	6,130	(+) 52 %	1,505
3.	2002-03	2,574	190	1,833	438	5,035	(-) 18 %	377
4.	2003-04	2,197	32	1,460	633	4,322	(-) 14 %	10,918
5.	2004-05	3,250	528	1,904	369	6,051	(+) 40 %	8,686
6.	2005-06	5,540	435	2,760	226	8,961	(+) 48 %	9,926
7.	2006-07	15,585	896	5,828	517	22,826	(+) 146 %	3,225
8.	2007-08 (P) +	24,573	2,291	7,679	292	34,835	(+) 53 %	20,328
9.	2008-09 (P) +	27,329	666	6,428	757	35,180	(+) 01 %	-15,017
10.	2009-10	20,734	770	3,831	1,169	26,506	-	20,518
	Sub. total (1 to 10 above) (from April '00 to December '09)	108,025	6,060	34,718	5,070	153,875	-	62,313
	Cumulative total (A)+(B) (from August '91 to December '09)	123,508	6,060	34,718	5,070	168,358	-	-

Source :
– RBI's Bulletin February 2010 dt 10.02.2010 (Table No. 44 – FOREIGN INVESTMENT INFLOWS).
– '#' Figures for equity capital of unincorporated bodies for 2007-08 & 2008-09 are estimates.
– "+" Data in respect of 'Re-invested earnings' & 'Other capital' for the years 2007-2008 & 2008-09 are estimated as average of previous two years

whereas in India it is far more export oriented.

Impact of FDI on Indian economy : Diagnosing the macro-view:

FDI impact on various macro economic variables can be classified into economic, political and social effects. FDI involves the transfer of managerial resources to the host country, So in the process the host country enjoys many benefits and bears some costs also. Some relevant facts have been compiled to further diagnose the changes in macro variables *i.e.* exports, private final consumption, forex, gross domestic investment, trade balance and balance of payments.

There has been tremendous progress in various sectors of the economy due to the inflow of foreign capital. Recently the GDP growth rate has crossed 9 per cent due to boom in manufacturing and service sector. Further, the sensex points in Indian Stock market have crossed 21000 points on November 4,2010. In addition, the foreign exchange reserves have crossed $204bn at the beginning of 2007. In addition, there has been improvement in the employment position, standard of living, infrastructure development, health and hygiene, GDP and NDP due to foreign inflows in India.

The impact of FDI on Indian economy has been analyzed by examining the trends in sector wise GDP growth rate, sector wise share in GDP, employment growth rate, inflation, exports and sensex points.

FDI approvals and inflows in India:

The government of India has been making all the possible efforts to attract FDI in India. The efficiency of country in attracting FDI that can be measured by comparing the growth rates of FDI approvals and inflows. The figures reveal that FDI inflows have increased from $4029m in 2001 to $26506m in 2005. So, it justifies the favourable environment of FDI for foreign investment.

Sector-wise growth in FDI:

The GDP of India has grown at a rapid rate during the post liberalization period due to overall growth rate in all the sectors of economy. the sector wise GDP growth rates are given in Table 1.

The GDP growth rate has been highest among the GDP growth rates of other sectors. However the GDP growth rate in agriculture sector has not only been low but also fluctuating. The GDP growth rate in industry has shown an increasing trend.

Table 2 : Sectors attracting highest FDI equity inflows — **Amount rupees in crores (US$ in million)**

Ranks	Sectors	2006-07 (April-March)	2007-08 (April-March)	2008-09 (April-March)	2009-10 (April-Dec., '09)	Cumulative Inflows (April '00 - Dec. '09)	% age to total inflows (In terms of rupees)
1.	Services sector	21,047	26,589	28,411	17,074	101,527	22
	(Financial and non-financial)	(4,664)	(6,615)	(6,116)	(3,547)	(22,796)	
2.	Computer software and hardware	11,786	5,623	7,329	2,857	42,353	9
		(2,614)	(1,410)	(1,677)	(595)	(9,549)	
3.	Telecommunications	2,155	5,103	11,727	11,442	39,809	8
	(Radio paging, cellular mobile, basic telephone services)	(478)	(1,261)	(2,558)	(2,359)	(8,735)	
4.	House and real estate	2,121	8,749	12,621	11,472	35,255	8
		(467)	(2,179)	(2,801)	(2,383)	(7,896)	
5.	Construction activities	4,424	6,989	8,792	10,543	32,720	7
	(Including roads and highways)	(985)	(1,743)	(2,028)	(2,218)	(7,409)	
6.	Power	713	3,875	4,382	6,088	20,099	4
		(157)	(967)	(985)	(1,258)	(4,448)	
7.	Automobile industry	1,254	2,697	5,212	4,696	19,763	4
		(276)	(675)	(1,152)	(976)	(4,365)	
8.	Metallurgical industries	7,866	4,686	4,157	1,613	13,118	3
		(173)	(1,177)	(961)	(336)	(3,060)	
9.	Petroleum and natural gas	401	5,729	1,931	1,085	11,262	2
		(89)	(1,427)	(412)	(219)	(2,612)	
10.	Chemicals	930	920	3,427	1,258	10,825	2
	(Other than fertilizers)	(205)	(229)	(749)	(264)	(2,398)	

Note: Cumulative sector wise FDI inflows (from April 2000 to December 2009)

Unemployment:

Unemployment has been a major problem in India. As employment is the basis for development and social upliftment of people, it is necessary to provide full employment to the labour force of the country. However, the position has improved during the post liberalization period. The figure indicates the improved unemployment position in India.

Years	Unemployment rate (%)
2002	8.8
2003	8.8
2004	9.5
2005	9.2
2006	8.9
2007	7.8
2008	7.2
2009	6.8

Source : http://www.indexmundi.com/g/g.aspx?c=in&v=74

Trend in exports:

Indian entrepreneurs initially gave less importance to the exports by considering the domestic market safe. However, the exports are inevitable to expand the market share and earn foreign exchange in a liberalized economy. The overall development of the country depends upon the level of foreign exchange earnings through exports. It is evident from the table that total exports from India have increased more than ten times in the last two decades.

Stock market growth:

The sensex points of the stock market of a country indicate the level of economic development. Increassing trend in the stock market indicates the booming economy of the country and *vice versa*. Further, sensex points act as a barometer for measuring and evaluating the financial performance of firms. The table reveals that the BSE sensex has gone up from 3085 points from 1996 to 21000 in 2010 which is surely a sign of foreign investors confidence in India.

Conclusion:

India being a fast developing country, needs huge amount of capital to invest in various sectors of economy to meet its developmental requirements. Capital has direct link to the growth and development of a country. Though the FDI

Table 3 : Share of top investing countries FDI equity inflows (Financial year-wise): Amount rupees in crores (US$ in million)

Ranks	Country	2006-07 (April-March)	2007-08 (April-March)	2008-09 (April-March)	2009-10 (April-Dec. '09)	Cumulative inflows (April '00 to Dec. '09)	%age to total inflows (in terms of rupees)
1.	Mauritius	28,759	44,483	50,794	42,924	204,196	44
		(6,363)	(11,096)	(11,208)	(8,913)	(45,778)	
2.	Singapore	2,662	12,319	15,727	8,188	42,040	9
		(578)	(3,073)	(3,454)	(1,707)	(9,518)	
3.	U.S.A.	3,861	4,377	8,002	7,577	35,536	8
		(856)	(1,089)	(1,802)	(1,584)	(7,919)	
4.	U.K.	8,389	4,690	3,840	1,841	24,746	5
		(1,878)	(1,176)	(864)	(38)	(5,611)	
5.	Netherlands	2,905	2,780	3,922	3,687	19,539	4
		(644)	(695)	(883)	(769)	(4,359)	
6.	Cyprus	266	3,385	5,983	6,419	16,468	4
		(58)	(834)	(1,287)	(1,340)	(3,613)	
7.	Japan	382	3,336	1,889	5,197	16,421	4
		(85)	(815)	(405)	(1,080)	(3,611)	
8.	Germany	540	2,075	2,750	2,581	12,069	3
		(120)	(514)	(629)	(539)	(2,712)	
9.	U.A.E.	1,174	1,039	1,133	2,824	6,830	1
		(260)	(258)	(257)	(587)	(1,507)	
10.	France	528	583	2,098	1,158	6,639	1
		(117)	(145)	(467)	(242)	(1,469)	
Total FDI inflows*		70,630	98,664	122,919	100,539	493,665 (110,761)	-
		(15,726)	(24,579)	(27,329)	(20,921)		

Note: (i) *Includes inflows under NRI Schemes of RBI, stock swapped and advances pending for issue of shares flows into India have gone up, yet it is very less as compared to some developing countries like China, Russia, Mexico, Brazil etc. In addition, there have been several achievements in India in terms of GDP growth rate, growth in industry and service sector, reduction in unemployment, reduction in poverty, improvement in standard of living, increase in foreign exchange reserve .In spite of that there is an urgent need to adopt innovative policies and good governance policies at par with international standards, to attract more and more foreign capital in various sectors of the economy to make India a developed country. **

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