

# Emerging trends of fdi inflows into india



It is now well known that most of the developing economies initiated liberalization in the late 1970s and early 1980s. Following the bandwagon, the government of India also announced a series of liberalization measures in the late 1980s and early 1990s, specifically with regard to trade and investment policy. In the present world, the developing countries are contending among each other to attract more foreign direct investment (FDI), which is contrary to the earlier perception of developing countries with regard to FDI. Such a policy change in developing countries is consistent with the changing world economy scenario from planned development strategy toward market oriented liberalization, privatization and globalization. The underlying objective behind liberal policy regime is to reap the benefits from the inflow of capital resources and other intangible assets like technology and management skills, on the one hand, and to develop competitiveness to access the world market, on the other. Likewise, in a world of intensifying competition and accelerating technological change, the complementary and catalytic role of FDI is very important.

In this context, the investment coming through MNCs can stimulate the growth process of the destination country, but the extent depends on the type of entry. If the entry of foreign investment adds to new production capacity (green field investment), then the growth impulse will be very strong and the entry of FDI can generate the critical minimum level of investment (or big push) which developing nations need to build their industrial base to achieve the takeoff stage. Alternatively, if entry of foreign investment is in form of M&A, then the growth impulse may not be so strong because the entry of MNCs in this form does not add to production capacity.

In addition to the preceding argument, the entry of transnational corporations (TNCs) forces the local firm to use cost effective methods and produce quality products to maintain their market share in the globalized world.

Given the growing importance of FDI in developing nations, it is important to keep in mind that the benefits trickling down from MNCs (in the form of technology spill over and competition) to local firms is not a direct consequence of foreign investment. These benefits can only be realized if local firms achieve minimum threshold level for absorbing spill over from MNCs, and if there exists effective intervention of state policy to streamline the spill over from MNCs to domestic producers. Moreover, it depends on the factor endowment in the country. For instance, the availability of quality infrastructure, scientific knowledge, human capital, research and development activities, etc., play a critical role in the trickle down process from MNCs to local firms. In the absence of adequate factor endowment and effective intervention of the regulatory authority, the entry of foreign investment may crowd out the local investment and lead to market concentration.

## **OBJECTIVE**

This study attempts to analyze the inflows of FDI into India in response to various liberalization measures announced by government of India since 1991. The objectives of the study are:

To analyze the evolution of FDI policy in India.

To examine the trends and patterns of FDI across developing countries.

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To examine the trends of FDI inflow at various levels:

India's share in world FDI

Country wise contribution of FDI in India

FDI inflows as a percentage of GDP

Ratio of actual to approval of FDI inflows

Sector wise growth of FDI inflows

The rest of the paper is organized as follows: It provides a detailed discussion on the policy change governing FDI inflows into India. The data and the methodology used in the paper are presented subsequently, followed by a discussion on the emerging trends and patterns of FDI in India during the post reform period. Finally, the conclusion is offered.

## **POLICY OVERVIEW**

In the early years of independence, India's development strategy was inward-oriented. The government emphasised on self-reliance to build a strong industrial base, especially after the Second Industrial Policy Resolution of 1956. Four phases were recognized in the evolution of India's FDI policy. The first phase of FDI was from 1948 to mid 1960. In this period the Government of India announced two industrial policy resolutions (1948 and 1956), where the entry of FDI was marked by cautious welcome. The controlling interest was expected to be with the Indians. During this period the Government introduced the Industries (Development and Regulations) Act, 1951 to regulate and control the development of the private sector. The

basic objective was to save scarce capital resources and to utilize these resources for the development of priorities. The second phase began by the mid-1960 and lasted till late 1970s. Monopolies and Restricted Trade Practices (MRTP) Act was introduced in 1969 to prevent concentration of economic power and to control monopoly. Thereafter, the Industrial Policy Statement (1973) was formulated which made licensing compulsory for all the firms above a certain size. In this period, external balance was not favourable and FDI outflows through transfer payment further deepened the situation. Therefore, the Government of India in 1973 formulated the Foreign Exchange Regulatory Act (FERA) that came into effect in January 1, 1974, to curtail the outflow of foreign exchange. With tightening of restrictions, this phase saw the exit of many leading MNCs, like IBM, Coca Cola, etc. from India.

By late 1970s, the country entered into the third phase with partial liberalization policy marked by selective relaxation of controls in line with the recommendation of various committees set up by the government in the context of industrial stagnation since the mid-1960s. In this phase particularly in the 1980s foreign firms were allowed to invest in India, but in collaboration with Indian firms. 100% foreign owned firms were permitted only in highly export oriented industries. Industrial Policy, 1980 was drafted with the aim to improve the competitiveness of domestic firms along with technological up-gradation and modernization. Likewise, MRTP Act was amended in 1985, the maximum asset limit for identified monopolies was raised and large businesses were permitted to invest in some restrictive sectors. A number of policy and procedural changes were announced in 1985

and subsequent years, with the objective to overcome the inefficiency developed in Indian industries during the restrictive policy regime. Following this partial liberalization phase, the GOI announced a series of liberalization measures in early 1990s with the aim of improving industrial competitiveness as well as to prepare Indian industries to stand on their own to face international competition.

In line with the liberalization measures announced during the 1980s, the government of India announced 'New Industrial Policy' (NIP) on July 24, 1991 as a part of 'New economic policy'. With the announcement of 1991 reform packages, India entered into the fourth phase known as the period of 'open door policy' or 'market led development strategy'. The NIP deregulated the industrial economy in a substantial manner. Among others, the fundamental aim of 1991 industrial policy was to improve efficiency of domestic industries and thereby to attain international competitiveness by improving competitiveness of Indian industries. To attain these objectives, the government includes a series of initiatives with regard to policies such as industrial licensing, public sector policy, MRTP Act, 1969, foreign investment and technology collaboration, industrial location policy, phased manufacturing programs for new projects, and FERA. The royalty payment limits were increased to encourage technology imports. Moreover, foreign equity holding level was raised to 50%, 74% and 100%. Thereafter, the government allowed free reparability, except where FDI approval was subject to specific conditions. Here has been a voluminous increase in the inflow of FDI into the country.

In the light of the above discussion, one can say that India's FDI policy became highly liberal in the post reform period. Now, FDI in India is approved through two routes: automatic and case by case government approval. In order to mobilize investment from non-resident Indians and overseas corporate bodies (OCB), the government has allowed them to invest in housing and real estate development sector. Furthermore, government has allowed them to hold up to 100% equity in civil aviation companies, where earlier only up to 40% foreign equity was allowed. As a result of the liberalization of India's highly regulated FDI policy, there has been a voluminous increase in the inflow of FDI into the country.

## **DATA SOURCES AND METHODOLOGY**

The data on FDI inflows were taken from various secondary sources such as Indiastat. com and secretariat for industrial assistance (SIA). SIA is published by ministry of commerce and industry and it provides data on FDI inflows at sector/industry level as well as information on FDI by source country is also available. Therefore, the data on FDI inflows of other countries were collected from World investment report, annually published by United Nations conference on trade and development (UNCTAD). From world investment report, we can get country wise trends in FDI inflows and outflows.

To obtain the trends and patterns of FDI in India, we calculated the compound average annual growth rate of FDI in various manufacturing industries. Further, the ratios of India's FDI inflows to the world FDI and to India's GDP were also calculated.

## **TRENDS AND PATTERNS OF FOREIGN DIRECT INVESTMENT IN INDIA**

It is observed from the aforementioned discussion, that the GOI has initiated various liberalization measures to attract FDI inflows into India. As a result of these policy reforms, FDI inflows showed a positive trend during the reform.

Given the policy initiatives announced by the GOI, the FDI inflows into India increased sharply in the post reform period (Table1). It is worth noting that the data since 200-01 are not compatible to the data prior to it. This is because the change in the definition of FDI to bring it line with international practices. In an effort to bring the Indian definition in line with international monetary fund definition, the coverage of FDI since 2001-02 includes, besides equity capital (i. e. RBI automatic route, SIA/FIPB route, NRI acquisition of shares, etc), reinvestment earnings (including earnings of FDI companies), and other direct capital (like, inter-corporate debt transactions between related entities).

Table 1 : FDI inflows into host countries

( in \$ bn)

Country Year

1980

1985

1990

1995



2000

2005

2007

Mexico

2. 1

1. 98

2. 63

9. 53

17. 98

20. 95

24. 69

Bazil

1. 91

1. 42

0. 99

4. 41

32. 78

15. 07

34. 58

China

0. 06

1. 96

3. 49

37. 52

40. 71

72. 41

83. 52

India

0. 08

0. 11

0. 24

2. 15

3. 59

7. 61

22. 95

Indonesia

0. 18

0. 31

1. 09

4. 42

-4. 5

8. 34

6. 93

Pakistan

0. 06

0. 05

0. 28

0. 49

0. 31

2. 2

5. 33

Sri Lanka

0.04

0.02

0.04

0.07

0.17

0.27

0.53

Malaysia

0.93

0.69

2.61

5.82

3.79

3.97

8.4

Philippines

0. 11

0. 11

0. 55

1. 46

2. 24

1. 85

2. 93

Singapore

1. 24

1. 05

5. 57

11. 54

16. 48

13. 93

24. 14

Thailand

0. 19

0. 16

2. 58

2. 07

3. 35

8. 05

9. 58

Source : UNCTAD Database

On the account of the removal of restrictions on FDI inflows by most of the developing economies since the late 1970s, it is not only important, but also worthwhile to compare the FDI inflows into India with that of the other developing economies (Table 1). It is noticed that the FDI inflows into the developing economies grew rapidly during the post post-reform era.

Comparing India's FDI trend with that of China and other countries reveals that it is not so remarkable, but compared to India's past FDI inflows, it has increased at an unprecedented rate in the recent period. Furthermore, the FDI inflows into India have improved at a much faster pace in comparison to that of the other developing countries since 2000 (see Table 1). For instance, the FDI inflow into India increased from \$7. 61 bn in 2005 to \$22. 95 bn in 2007. As per UNCTAD, India emerged as the second most important destination after China for foreign investors.

Table 2 presents the share of India's FDI in the world FDI. It is evident that India's share in world FDI has increased considerably during the liberalization

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period. For instance, India's share in the world FDI increased from 0.11% in 1990 to 0.79% in 2005, and subsequently to 1.25% in 2007. However, it is observed that FDI inflows into India have fallen in 2000. This slowdown in FDI might be attributed to the negative spill over caused by the East Asian Crisis in 1997.

Table 2 : Share of India in World's Total FDI inflow

Year

India

World

India's Share in World FDI (%)

1990

237

207278

0.11

1995

2151

341041

0.63

2000

3585

1398183

0. 26

2005

7606

958697

0. 79

2007

22950

1833324

1. 25

Source: UNCTAD Database

Table 3 presents the share of major foreign investors (countries) in India. It is evident that Mauritius emerged as one of the largest foreign investors in India during the period 1991-2007. The firm based in Mauritius accounted for about 41% of total FDI inflows into India during the period August 1991-March 2007. The US (11. 39%), the Netherlands (5. 67%), and Japan (5. 02%) followed at second, third and fourth positions, respectively. The major chunk of FDI inflows into India from the top investors is primarily invested in fuels, electrical equipment, telecommunications, food processing, and service,

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power, and transport sectors. Indeed, it needs to be pointed out that the FDI inflow from Mauritius to India is misleading. This is so because Mauritius has low rates of taxation and an agreement with India on double tax avoidance regime. In order to get benefits out of the low tax agreement between Mauritius and India, large number of foreign firms started dummy companies in Mauritius, and then invested in India via Mauritius.

Table 3: Share of different countries in India's Total FDI inflow- Aug'91 to Mar'07

Country

Share in Total FDI inflow: August 1991-March 2007

Mauritius

41. 53

US

11. 39

The Netherlands

5. 67

Japan

5. 02

Singapore

4. 63

UK

4. 14

Germany

3. 46

France

1. 78

Switzerland

1. 58

All Other

20. 84

**Total****100**

Source: SIA

FDI inflows into India as percentage of gross domestic product (GDP) increased from 0. 03% in 1990-91 to 0. 66% in 1995-96 (Table 4). FDI inflow further increased from 0. 96% in 2000-01 to 2. 36% in 2006-07. The observed rise in FDI inflows was approximately 79 times between 1990-91 and 2006-07. This implies that FDI inflow as a percentage of GDP has improved significantly during the liberalization era. Some researchers state <https://assignbuster.com/emerging-trends-of-fdi-inflows-into-india/>

that the sudden rise in FDI was the result of liberalization of India's highly regulated FDI policy and improvement in structural factors, such as market size, quality of infrastructure, tax concession, etc.

Table 4: India's FDI Inflows as % of GDP

Year

FDI Inflows as percentage of GDP

1990-91

0.03

1995-96

0.66

2000-01

0.96

2005-06

1.05

2006-07

2.36

Source: RBI

The change in approvals and the percentages of realization of FDI over time indicates that India's approach (policy and procedures) towards FDI has undergone significant changes. Table 5 shows that FDI approvals were much higher than the actual realization of FDI inflows in the early years of economic reforms in India. This may be because FDI approval took time for actual realization. Since 2002, the realization of FDI inflow has been more than that of approval of FDI. For instance, actual realization of FDI inflow increased from 18.1% in 1992 to 71.67% in 2000 and further to 218% in 2006. This is because of the setting up of the foreign investments implementation authority for quick transformation of FDI approvals into realizations. Further, routing most of the FDI through automatic approval enabled India to turn FDI approvals into actual inflows of FDI.

Table 5 : Year -wise FDI approvals and inflows ( In Rs. Cr)

Year(Jan-Dec)

Amount of FDI Approvals

Amount of FDI Inflows

Percentage Realization (Actual to Approval)

1991

504.9

353.48

70.01

1992

3817. 89

691. 2

18. 10

1993

8861. 8

1861. 96

21. 01

1994

8955. 22

3112. 23

34. 75

1995

30882. 11

6485. 36

21. 00

1996

30886. 05

8752. 36

28. 34

1997

50388. 86

12989. 76

25. 78

1998

27589. 86

13269. 21

48. 09

1999

25140. 28

10166. 71

40. 44

2000

17236. 97

12353. 73

71. 67

2001

20939. 68

16777. 75

80. 12

2002

11058. 1

18195. 56

164. 55

2003

5416. 59

11617. 17

214. 47

2004

8741. 25

17266. 52

197. 53

2005

7899. 53

19299. 09

244. 31

2006

23003. 61

50357. 25

218. 91

Total

281322. 4

203549. 19

72. 35

Source: SIA

Table 6 shows the compound growth rate of FDI inflows in some selected manufacturing industries in India. The growth rate of FDI inflows was found to be positive in selected manufacturing industries, which indicated that the inflow of foreign investment rose across various industries during the period 1996-2006. However, the growth rate of FDI inflow differs from industry to industry. For more information, visit <https://assignbuster.com/emerging-trends-of-fdi-inflows-into-india/>



industry. Some industries such as electrical equipment, transportation, telecommunications, metallurgical, and drugs and pharmaceuticals, showed very high rate of growth of foreign investment compared to the fuel and chemical industries.

Table 6: Sector-Wise Compound Growth Rate of FDI Inflow in selected industries of India (1996-2006)

Sectors

Compound Growth Rate

Electrical Equipment (incl. S/W and Elec.)

22. 41

Transportation

18. 69

Telecommunications

14. 35

Fuels (Power and Oil refinery)

7. 97

Chemicals (Other than Fertilizers)

6. 96

Drugs and Pharmaceuticals

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10. 97

Metallurgical

14. 63

Miscellaneous Mechanical and Engineering

6. 78

Source: Indiatat. com and SIA

## **CONCLUSION**

The main objective of the study was to explore the emerging trends of FDI inflows into India against the backdrop of a series of liberalization measures introduced in mid-1980s and further in 1991.

The major findings of the study are as follows:

Firstly, it is observed that India's FDI policy has passed through four major phases. A major change has been observed in the fourth phase (started in 1991) of FDI policy, wherein the restrictions on FDI inflows were eliminated to a considerable extent. Now, FDI in India gets approved through two routes: automatic and case by case approvals. Secondly, the FDI inflow into India has increased sharply during the post reform period. India's share in world's total FDI inflow also experienced a positive trend and increased by 11. 36 times between 1990 and 2007. Further, in comparison to China and other East Asian economies, the trend of FDI inflow into India was not very impressive till late 1990s, but improved remarkably in the subsequent period particularly after 2000. As per world investment report, India emerged as the

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second most important destination after China, foreign investors in the recent period.

Thirdly, the ratio of India's FDI inflows to GDP also increased between 1990-91 and 2006-07, from 0.03% in 1990-91 to 2.36% in 2006-07. Furthermore, the percentage of actual realization of FDI inflow to approval has improved amazingly after 2000. The setting up of the foreign investment implementation authority for quick transformation of FDI approvals into realization and routing most of the FDI through automatic approval enabled India to turn FDI approvals into actual inflows of FDI. Nonetheless, the growth rate of FDI inflows in selected manufacturing industries was also found to be positive though it varied from industry to industry. The concentration of FDI has shifted from manufacturing sector to services sector as India's service sector has experienced high growth rate in the recent years.

From the above, it is evident that FDI inflow into India increased sharply in the post reform period. The trend of FDI has been positive in India and at global level in the post reform period. The increasing inflow of FDI into India is partly attributed to rising inflow of FDI at global level and partly to liberalization policies proclaimed in the late 1980s and early 1990s. Further, the MNCs expanded their activities in other developing countries with the objective of reducing their cost of production on the one hand, and to search for new markets on the other.