

# Impact of fdi flows outflow on the indian economy



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## **Abstract**

This paper discusses the trends in India's outward FDI over the last decade and attempts to identify the factors for the same. The main aim is to help policy makers with insights regarding levers which will help in improving FDI outflows and to stimulate further research in foreign investment from emerging economies. 287 conditions of investment from India by Indian companies in 17 sectors have been taken for the analysis. The paper elaborates on the concept of studying the impact of ownership, location and internalization variables on India's foreign investment. An analysis of sector wise of entry strategy, reason of entry and geographical analysis has been performed. Overall, it has been found that acquisitions was the major way of entry for Indian firms who are investing abroad and seeking new markets. The paper also describes the policy changes which had impacted FDI flow from India and the relation of outward FDI with macro-economic indicators like Fischer Open Differential and GDP.

## **Objective of the study**

We would like to study outward FDI flows from the emerging economies, specifically to the Indian context.

- An analysis of FDI flows from different sectors of the Indian Economy will be done
- To see what is the intent of investment, the mode of entry, and the macroeconomic factors that affect FDI flow.
- To find out the impact of the Fischer Open Differential due to the FDI flow.

## Introduction

The first overseas Indian venture was a textile mill set up in Ethiopia in 1959 by the Birla Group of companies, India's second largest business conglomerate at the time (kudaisya 2003). The following year, the Birla Group set up an engineering unit in Kenya. Sustained growth in Indian overseas investment could be seen starting around the late 1970s when the industrial licensing system became much more stringent as part of the government's move to control big businesses. By 1983, there were 140 foreign investment projects in operation and another 88 in various stages of implementation (Iall 1986). The total number of approved projects had reached 229 by 1990 (kumar 2007). Most of the foreign affiliates set up during this period were small- or medium-scale ventures; total approved equity during the period 1975-1990/1991 amounted to only \$220 million. The second wave of internationalization of Indian firms began from about 1995 and gathered momentum as foreign exchange restrictions on capital transfers for overseas acquisitions liberalized in successive stages from 2000 (nagaraj 2006). There was a surge in outward investment from 2005. The number of approved projects increased from 220 in 1990/1991 to 395 in 1999/2000 and to 1, 595 in 2007/2008 (kumar 2008). Total FDI outflow from India increased from about \$25 million in the early 1990s to nearly \$14 billion in 2007. India's share in total developing economy FDI outflows remained below 0. 5 percent throughout the 1990s, but increased continuously since, reaching nearly 6. 0% in 2007 (see table 1 and Figure 1). India remains a net FDI recipient, even though the gap between outflows and inflows has been sharply narrowing over the past few years. In 1990, annual

outflows, on average, amounted to 7 percent of inflows. This increased from about 30 percent to 60 percent between 2000-2005 and 2005-2007.

The data in table 1 help in understanding India's relative position in the world as a source country of FDI. In the early 1990s, India's share in FDI outflows from developing economies was the lowest compared to the four large emerging market economies used as comparators (Brazil, People's Republic of China [PRC], Mexico, and South Africa). Over the ensuing years, India's share has grown faster than those of the comparators. In 2004-2005, it surpassed that of South Africa and in 2006-2007, it surpassed that of Mexico. The share of FDI outflows in gross domestic capital formation (GDCF) in India has likewise increased much faster than the other four economies and the average for all developing economies during the period 1994-2007.

Figure 2 compares the outward FDI from the PRC and India in terms of the percentage contribution to total developing economy outward FDI and relative to GDCF in each economy. During 2006-2007, on average, the PRC accounted for 7.3 percent of the total outward FDI from developing countries compared to 3.2 percent for India, although the gap has been narrowing over the years. By contrast, relative to GDCF, outward FDI from India on average is larger compared to that from the PRC. The difference widened sharply following the significant liberalization of the outward FDI regime in India during 2004-2005. During 2005-2006, the contribution of outward FDI to GDCF in India (4.4 percent) was more than twice as large as that of the PRC (1.7 percent).

## **Theories of FDI flows**

The paper on FDI outflows by John Dunning in which he explains the same through the OLI (Ownership, Location and Internalization) framework.

### **DUNNING'S Concept**

#### **OWNERSHIP**

An MNC faces several disadvantages the moment they entrench the domestic firm when it enters an external market different from its country of origin. However, a firm chooses to enter a foreign market if it has advantages which outweigh the disadvantages outlined above. These include access to natural resources, intellectual property, strong domestic / global brand which become a competitive advantage for the companies.

#### **LOCATION**

The location specific concept involves the attractiveness of the foreign market as a destination for entry by a firm. There are 3 ways how a foreign market can differentiate itself-

1. Economic – Size of the foreign market, market concentration, growth rate, availability of talent, infrastructure, competitive cost structures etc.
2. Political – These include the political risk of the country, the judicial mechanisms and their transparency, ease of doing business, labour laws etc.
3. Social – These include similarities of culture, ways of doing business, social structure between the country of origin of the firm and the foreign country etc.

## INTERNALIZATION

A firm has to choose between various entries modes into foreign markets starting from marketing alliances, licensing and greenfield ventures and to full blown acquisitions. The decisions are made keeping in view the tradeoff of transaction costs versus internalization costs. In poorly operating markets firms prefer to avoid high costs of external transactions. The intensity of the regulation of the foreign market is another parameter which determines the internalization decision.

## HYMER'S THEORY

Hymer's theory explains that MNEs are elements of market imperfections. There are two causes for imperfections - removal of competition and monopolistic powers. Hymer states that investment made abroad gives them the ability to use its worldwide operations to separate markets and reduce competition. MNEs control assets to minimize risks and increase their monopolistic power by creating entry barriers. Hymer's analysis is based on structural imperfections which are caused by large scale economies, having knowledge, wide distribution networks, product diversification and credit advantages

## ALIBER'S MODEL

Aliber's theory says that MNCs invest in foreign assets as the MNC's have the ability to hold assets in different currencies and thus take advantage of structural and transactional imperfections in foreign exchange markets. He also outlines that the firm will face the same operational problems abroad as in the domestic market and that is not a decision making criterion for firms.

## **VERNER'S THEORY**

Vernon's location theory says that a MNE's often acquire low cost resources than that of nation's company as the cost to a MNE is just the marginal cost to the system This helps the NEs acquire factor inputs and resources at a cost prevailing in the home country while MNEs acquire them at the best price worldwide having lower labor and input costs. This difference between national cost and marginal cost will be a key driver of FDI worldwide.

## **Literature Review**

We have come across various articles and research papers related to our topic:

The papers explore the uneven beginnings of FDI in India and examine the developments (economic and political) relating to the trends in two sectors: Industry and Infrastructure and sub sector Telecom. The papers laid the relation between institutions in emerging markets and the entry strategies chosen by foreign direct investors. The merits of alternative strategies from investors' perspective as well as the impact on the host country were investigated. For this purpose FDI strategies were investigated and were compared with four important emerging markets India, Egypt, South Africa and Vietnam. The papers also enlightened the sector wise FDI inflows in India and the reasons for industrial sectors attracting the highest FDI inflows. The best part of the analysis was in its specific focus on the implications of changes in trade and investment policy regimes and the overall investment climate for internationalization of domestic companies and the nature of their global operations. The findings cast doubt on the popular perception of the recent surge in outward foreign direct investment from India as an

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unmixed economic blessing, given the remaining distortion in the domestic investment climate.

Foreign Direct Investment in India: A Critical Analysis of FDI from 1995-2005 by Kulwindar Singh (Center for Civil Society, New Delhi Research Internship Programme, 2005)

Survey of FDI in India by Sumon K. Bhaumik (London Business School, 2003).

Foreign Direct Investment Inflows in India- Opportunities and Benefits by Syed Khaja Safiuddin (Assistant Professor, Department of Management and Commerce, 2010)

Outward Foreign Direct Investment from India by Prema- Chandra Athukorala (Asian Development Bank, 2009)

### **Scope of the study**

The scope of the study was restricted to analyzing the dependence of foreign investment on ownership variables only . The scope of the study was further restricted owing to the lack of availability of data on foreign investment by Indian firms. There was, 287 data of foreign investment from India were collected. The data spans across 17 sectors as will be discussed later. The lack of data posed several restrictions on the scope of the study such as:

It was not possible to do trend analysis for foreign investment from India

The data was available for only 99 records. The size of the investment could be found for 65 records.



## India's Outbound Data: Trends and Empirical Data

A majority FDI outflows has been for quest for raw materials as India is a raw material scarce country. For instance, Tata Steel was more into securing coal assets in Indonesia with better quality coal which was not available in the country where private players are not allowed and there was too much of regulation. The Pharmaceutical sector has gone on an acquisition spree mainly for IP and access to markets including distribution networks.

In recent times India's FDI have been in acquisitions in the IT and IT services sectors. Indian enterprises have developed expertise and capabilities in IT services which they leverage and enter global markets. This gives them the opportunity to find newer clients at lower costs as a consequence of a booming local stock market and low P/Es in economies abroad. For example HCL Technologies acquired Axon for 440 million pounds. India's FDI flows in recent times has been to acquire crude oil assets in a bid to secure the energy needs of the country through ONGC Videsh Ltd.

Figure I: FDI outflows are expected to double over the next 5 years with a CAGR of 16. 7%

Source: EIU Country Data

Actual Figures

Projected Figures

## **Values**

### **Row Labels**

#### **Sum of Inward FDI**

#### **Sum of Outward FDI**

1996

2125

119

1997

2525

240

1998

3619

113

1999

2633

47

2000

2168

80

2001

3585

509

2002

5472

1397

2003

5627

1669

2004

4323

1879

2005

5771

2179

2006

7606

2978

2007

19622

12842

2008

22950

13649

**Grand Total****88026****37701**

India's FDI Inflows and Outflows (US \$ Millions)

Source: UNCTAD 2008

Figure II: Graph showing the FDI outflow in the next 5 years.

**Research Methodology**

A large number of data on the FDI outflows have been gathered (about 300) using press releases from the firms' websites and annual reports, news articles and clippings, databases such as Thompson Reuters and Capitaline, industry forums and various other sources. The variables of ownership, location and internalization were further elaborated in detail later. These

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have been filtered by virtue of their sales, with those having sales greater than 100 crores making it to the final list of firms. This data has been gathered from Center for Monitoring of Indian Economy (CMIE). For this study, number of sectors was limited to 17 as shown in Table I below.

**Number of instances**

**IT**

**36**

**Pharmaceuticals**

**37**

**Auto Components**

**20**

**Construction**

**32**

**Telecom**

**28**

**Petroleum Products**

**7**

**Oil & Gas Mining**

**24**

**Steel**

**20**

**Dyes**

**4**

**Paints**

**3**

**Machinery/Capital**

**Goods****14****Non Ferrous Metals****2****Auto****30****Cosmetics,****toiletries, etc.****8****Tyres & Tubes****6****Diversified****1****Food Products****15****TOTAL****287**

Table I: Total foreign investment by each sector

We have restricted the research to determining the impact of ownership variables on FDI outflows from India. Two types of research were – qualitative and quantitative. Qualitative research includes the trend of FDI flows, which has been shown through different modes of entry and further was analyzed for specific trends within sectors. This shows why different

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sectors use different routes for entering into foreign markets for example, pharmaceutical companies enter through alliances while manufacturing firms go for acquisitions and IT firms go for both routes depending on the objectives. For quantitative analysis, this is done in the broad section of determining whether there is an outward flow of foreign direct investment from India. Another analysis has been done on the lifecycle of the firm. The mode of entry might also depend on the risk taking ability of the management.

The research objectives were translated into the following questions, which were then tested using statistical analysis:

Q1: Whether FDI is the preferred mode of entry for foreign investment by Indian companies?

Q2: Whether the intent of foreign investment by Indian companies is market seeking, product, brand or resource seeking or technology seeking?

Q3: Whether foreign investment by Indian companies is more towards less income countries as well as in certain cases where FDI by Indian companies is attributed towards certain geographical aspect?

Q 4: Whether FDI is related to other macroeconomic indicators such as GDP (non agricultural)?

## **Q 1: MODE OF ENTRY**

In total 287 instances of FDI outflow was classified into the following categories:



Greenfield: It refers to the opening up of a new branch, office or setting up of a new wholly owned subsidiary in the target country

Alliance: Alliances are arrangements such as Memorandum of Understanding signed with the universities for technological research

## **Joint Venture**

Expansion: This refers to the instance which is related to the expansion of its existing operations such as opening up of a new office.

Acquisition: Acquisition if the Indian company refers to acquiring a majority stake in the equity of the foreign company or acquiring assets of a foreign company or acquired.

## **Minority Stake**

Here we can see that, the main entry mode for India firms has been acquisitions accounting for 33.80% of the total Indian outward investment from the instances studied. This is closely followed by joint ventures, Greenfield operations and expansion for 19.86%, 17.07% and 16.03% respectively. Table II presents a detailed sectoral picture of the instances based on the way of entry.

## **Figure III: India's outward direct investment based on mode of entry**

## **Table II: Sectoral break up of foreign investment depending on the mode of entry**

Due to limited amount of data, a sector wise analysis to identify trends within each sector in the case of the mode of entry could not be done.

However, based on the data available following trends (see Table 3) were discovered:

Acquisitions were the most common modes of foreign investment in case of automobile components, pharmaceuticals, capital goods, cosmetics & food products and tyres & tubes.

Greenfield investments are selected mode of investment in case of IT, Petroleum Products and Oil & Gas Mining.

Joint ventures accounting for around 60. 71% of the entire foreign investment of telecom companies

Construction companies resorted to expansion of existing foreign operations

Sectors most likely show foreign direct investment include auto & auto components, fast moving consumer goods, technology based companies such as pharmaceuticals, IT, and capital goods.

### **Table III: Sectoral distribution of mode of entry**

#### **Q 2: INTENT OF INVESTMENT**

The main reason for investing abroad was identified as follows:

Market Seeking: This is driven by gaining access to local or regional market which would help prevent some operational costs eg: distribution cost.

Technology or Brand Seeking: Companies also invest in order to gain access to new technology or acquisition of some brands or products.

Resource Seeking: This is driven by gaining access to natural resources.

In each of the 287 instances of investment was evaluated based on available information. In certain cases, investment was found out to have multiple characteristics or intents. For instance, a foreign investment could be made to both get access to a new market as well as to a new technology. Same weight age was given to each of the elements: therefore, in this case both market seeking and technology seeking will get a score of 0.5. The results, are given below

#### **Table IV: Foreign investment based on investment**

Figure 4 below summarizes the intent of entry for the instances studied. It can be seen, the foreign investments made by Indian companies have been mainly market seeking. Over 52% of the total investments made abroad were for market seeking while 32% of the investments are made to seek new technologies, brands or products. Resource seeking investments form only 16% of the total investments made by Indian companies as a whole.

#### **Figure IV: Foreign investment based on investment**

A sector wise analysis of the foreign investment offers more insights as follows (see Table 5):

Market seeking foreign investment is the driving force in case of IT, pharmaceuticals, auto components, construction, telecom, and tyres & tubes.

Technology or brand or new product seeking kind of foreign investment intent is predominant in case of capital goods, auto and toiletries and food products.

As expected, oil and gas mining, petroleum products and non ferrous metals exhibit resource seeking as their predominant intent of foreign investment.

## **Table V: Sectoral distribution for investment**

### **Q 3: TARGET COUNTRY**

The target countries of investment were classified based on two parameters:

Income

Continent

### **INCOME OF COUNTRY**

Based on income, the target countries were classified into three categories

(based on

United Nations Human Development Report 2007&#160;08):

High Income: The high income countries are those with GNI per capita of USD 10, 726 or more in 2005.

Middle Income: These are countries with GNI per capita of USD 876 to USD 10, 275 in 2005

Low Income: These are countries with GNI per capita of USD 875 or less in 2005 Based on the above classification; India is categorized as a low income country.

The target country of the 287 conditions of foreign investment was determined. The data is as shown in Table VI. The overall results are also summarized in Figure V.

## **Table VI: Investment based on country**

### **Figure V: Foreign Investment based on income**

Figure V show that most of the foreign investment from India has been to countries with high income. As seen in Table VI, high income countries account for 61. 32% of the total foreign investment from India.

Table VII helps us analyze the sector wise trends in terms of target country of investment.

The following inferences can be drawn based on the data available:

The IT, pharmaceuticals, auto & auto components, toiletries & food products, capital goods and construction sector had most of the foreign investment is made to high income countries include.

The sectors where majority of the investment has been made to middle income countries include oil & gas mining.

Petroleum products have invested mainly in low income countries

For metals (ferrous & non-ferrous) sectors, the investment has been equally distributed between high income countries on one side and middle & low income countries on the other.

## **Table VII: Table showing foreign investment based on the country's income**

### **TARGET COUNTRY CONTINENT**

A geographical analysis of the collated data was also done. The target countries were identified into 6 major geographies as follows:

North America

South America

Asia

Europe

Middle East

Africa

Table VIII and Figure VI summarize the inferences drawn from this data. In certain instances, the target country could not be singularly identified – for instance if a JV is formed among three countries. As a result, the total no of instances is 290 instead of 287 (See Table VII)

### **Table VIII: Foreign investment based on geography**

Figure VI shows that Europe and Asia together account for about 54. 48% of the instances of foreign investment, while North America accounts for another 20. 69%.

### **Figure VI: Foreign investment based on geography**

Table IX shows the sector wise percentage distribution of geography of investment.

From the table it is apparent that:

Sectors like non ferrous metals, IT, cosmetics & toiletries and pharmaceuticals have major investments in North America.

South American investments largely have oil & gas mining

In Asia, paints, metals (steel and non-ferrous metals), telecom and tyres & tubes predominant sectors from India

Europe is a preferred destination for companies in sectors such as capital goods, auto and auto components

Construction companies target their foreign investment in Middle East.

Foreign investment from Indian companies in petroleum products occurs in Africa

### **Table IX: Sectoral distribution of foreign investment depending upon geography**

#### **Q4: CORRELATION WITH OTHER MACROECONOMIC INDICATORS**

India's outward FDI was correlated against India's non agricultural GDP and portfolio investments out of India to assess the impact of growth in the economy on India's outward FDI.

India's outward FDI and Non agricultural GDP

The results are summarized in the table below.

From the correlation results, it can be concluded that India's outward FDI has a positive relation with the India's non agricultural GDP. However, the negative coefficient in the equation implies that FDI out of India starts only after a certain threshold of INR 3, 59, 468 crores is crossed.

## **Table X: India's outward FDI vs. GDP (Non-Agricultural)**

### **IMPACT OF POLICY CHANGE**

Changes in the regulation policies in India have also been a major contributor to the observed increase in investment outflow from India, especially the year 2000 onwards. Some of the key policy changes which have impacted investment outflow from India are:

#### **Reserve Bank of India Notification No. FEMA. 40/2001RB; 2 March 2001**

Overseas investments are allowed to be funded up to 100% by American

The three years profitability condition requirement has been removed for Indian companies making overseas investments under the automatic route

Overseas investments are opened to registered partnership firms and companies that provide professional services. The minimum net worth of Rs. 150 million for Indian companies engaged in financial sector activities in India has been removed for investment abroad in financial sector

Depository Receipt/General Depository Receipt proceeds; up from the previous ceiling of 50%.

#### **Reserve Bank of India Notification No. FEMA. 49/2002RB; 19 January 2002**

Indian companies in Special Economic Zones can freely make overseas investment up to any amount without the restriction of the \$100 million ceiling under the automatic route, provided the funding is done out of the Exchange Earners Foreign Currency Account balances



**Reserve Bank of India Notification No. FEMA. 53/2002RB; 1 March 2002 and FEMA. 79/2002RB; 10 December 2002**

The annual limit on overseas investment has been raised to \$100 million (up from \$50 million) and the limit for direct investments in South Asian Association for Regional Cooperation countries (excluding Pakistan) and Myanmar has been raised to \$150 million (up from \$75 million); for Rupee investments in Nepal and Bhutan the limit has been raised to Rs. 700 crores (up from Rs. 350 crores) under the automatic route

**Reserve Bank of India Notification No. FEMA. 49/2002RB; 2 March 2001**

An Indian party which has exhausted the limit of \$100 million in a year may apply to the Reserve Bank of India for a block allocation of foreign exchange subject to such terms and conditions as may be necessary

**Reserve Bank of India Notification No. 83/RB 2003; 1 March 2003**

Indian companies can make overseas investments by market purchases of foreign exchange without prior approval of the Reserve Bank of India up to 100% of their net worth; up from the previous limit of 50%

An Indian company with a proven track record is allowed to invest up to 100% of its net worth within the overall limit of \$100 million by way of market purchases for investment in a foreign entity engaged in any bona fide business activity starting fiscal year 2003-2004. The provision restricting overseas investments in the same activity as its core activity at home of the Indian company are removed. Listed Indian companies, residents and mutual funds are permitted to invest abroad in companies

listed on a recognized stock exchange and in company which has the shareholding of at least 10% in an Indian company listed on a recognized stock exchange in India.

### **Changes brought about in fiscal year 20032004**

Indian firms are allowed to undertake agricultural activities, which was previously restricted, either directly or through an overseas branch

Investments in joint venture or wholly owned subsidiary abroad by way of share swap are permitted under the automatic route;

In January 2004, the Reserve Bank of India further relaxed the monetary ceiling on Indian companies' investment abroad. With effect from fiscal year 2003-2004, Indian companies can invest up to 100% of their net worth without any separate monetary ceiling even if the investment exceeds the \$100 million ceiling previously imposed. Furthermore, Indian companies can now invest or make acquisitions abroad in areas unrelated to their business at home.

In 2005, banks were permitted to lend money to Indian companies for acquisition of equity in overseas joint ventures, wholly owned subsidiaries or in other overseas companies as strategic investment.

In 2006, the automatic route of disinvestments was further liberalized. Indian companies are now permitted to disinvest without prior approval of the RBI in select categories. To encourage large and important exporters, proprietary/unregistered partnership firms have been allowed to set up a JV/WOS outside Indian with the prior approval of RBI.

In 2007, the ceiling of investment by Indian entities was revised from 100 per cent of the net worth to 200 per cent of the net worth of the investing company under the automatic route of overseas investment. The limit of 200 per cent of the net worth of the Indian party was enhanced to 300 per cent of the net worth in June 2007 under automatic route (200 per cent in case of revisited partnership firms). In September 2007, this was further enhanced to 400 per cent of the net worth of the Indian party.

The Liberalized Remittance Scheme (LRS) for Resident individuals was further liberalized by enhancing the existing limit of US\$ 100. 00 per financial year to US\$ 200. 00 per financial year (Aprilâ€ March) in September 2007.

The limit of portfolio investment by listed Indian companies in the equity of listed foreign companies was raised in September 2007 from 35 per cent to 50 per cent of the net worth of the investing company as on the date of its last audited balance sheet. Furthermore, the requirement of reciprocal 10 per cent shareholding in Indian companies has been dispensed with.

The aggregate ceiling for overseas investment by mutual funds, registered with SEBI, was enhanced from US\$ 4 billion to US\$ 5 billion in September 2007. This was further raised to US\$ 7 billion in April 2008. The existing facility to allow a limited number of qualified Indian mutual funds to invest cumulatively up to US\$ 1 billion in overseas Exchange Traded Funds, as may be permitted by the SEBI would continue. The investments would be subject to the terms and conditions and operational guidelines as issued by SEBI.

Registered Trusts and Societies engaged in manufacturing/educational sector have been allowed in June 2008 to make investment in the same sector(s) in a Joint Venture or Wholly Owned Subsidiary outside India, with the prior approval of the Reserve Bank.

Registered Trusts and Societies which have set up hospital(s) in India have been allowed in August 2008 to make investment in the same sector(s) in a JV/WOS outside India, with the prior approval of the Reserve Bank.

As can be seen from the above chart, the outward FDI in India really picked up after Q1 2006.

## **CONCLUSIONS**

The major mode of entry for India firms in the last 5 years has been acquisitions which are around 33.80% of the total Indian outward investment from the instances studied; this is closely followed by joint ventures. This shows that Indian firms have the confidence to venture abroad and maintain operational control of the acquired company. Most foreign investments made by Indian companies have been market seeking. Over 50% of the total investments made abroad are for market seeking while 33.78% of the investments are into seeking new technologies, brands or products. This is seen mainly towards the service sector showing that the required competencies are being built at home while small forei