FDI Role in Indian Economy

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Abstract

Foreign Direct Investment refers to capital inflows from abroad that are invested in or to enhance the production capacity of the economy. FDI and economic growth has long been a subject of great interest in the field of international growth. In the era of volatile flows of global capital, the stability of FDI emerges as an effective channel to faster growth in developing countries. It plays an important role in the long-term development of a country not only as a source of capital but also for enhancing competitiveness of the domestic economy through transfer of technology, strengthening infrastructure, raising productivity and generating new employment opportunities. In India, FDI is considered as a developmental tool, which helps in achieving self-reliance in various sectors and in overall development of the economy.FDI is also very important for governance. India after liberalizing and globalizing the economy to the outside world in 1991, there was a massive increase in the flow of foreign direct investment. Foreign Direct Investment (FDI) is often seen as important catalysts for economic growth in the developing countries like India. FDI affects the economic growth by stimulating domestic investment, increasing human capital formation and by facilitating the technology transfer in the host countries. The main purpose of this research study is to investigate the impact of FDI on the economic growth of India, from the period of 1990 to 2013.

Role and Need of FDI in Economic Development of India:

India's economic policy reforms, adopted at the backdrop of historical economic crises of 1990-91 and some notable changes in global economic set up, have changed the whole structure of Indian economy since 1991. Among other things, the reforms have evolved in opening the economy, making it more competitive, getting the government out of the huge mode of regulation, empowering the states to take more responsibility for economic management and creating a kind of competition among the states for foreign investors.Indian economy had experienced major policy changes in early 1990s. The policy of Liberalization, Privatization and Globalization (LPG) aimed at making the Indian economy a fast growing and globally competitive economy. The series of reforms undertaken with respect to industrial sector, trade as well as financial sector have made the economy more efficient. The term globalization refers to the integration of economies of the world through uninhibited trade and financial flows, and also through mutual exchange of technology and knowledge.Since July 1991; the Government has consistently pursued the policy of attracting larger volumes of foreign investment to augment the resource availability in infrastructure and other critical areas of the economy.

Section I

INTRODUCTION

FDI has worked as an engine of growth in the past and more in modern era. The outward-oriented growth strategy adopted by the newly industrialized economies of Asia such as Singapore, South Korea, Taiwan and Hong Kong have enabled them to overcome the constraints of least resource developing economies. In India too, FDI has acted as a catalyst for the growth of the economy. FDI contributes in the process of economic development in many ways –

Foreign direct investment is investment of foreign assets into domestic structures, equipment, and organization. It does not include foreign investment into the stock markets. It is especially important for its potential to transfer knowledge and technology, create jobs, boost overall productivity, enhance competitiveness and entrepreneurship and ultimately eradicate poverty through economic growth and development. India still suffers from weaknesses and constraints, in terms of policy and regulatory frame work, which restrict the inflows of FDI. Prior to economic reforms initiated in 1991, FDI in India was discouraged by (a) imposing severer limits on equity holdings by foreigners and (b) restricting FDI to the production of only a few reserved items. The Foreign Exchange Regulation Act (FERA), 1973 has now been replaced by the new legislation known as foreign Exchange Management Act. (FEMA). All foreign investors were virtually driven out from Indian industries by FERA, compared to the earlier regulations FEMA is more liberal and less restrictive.

Section II

TREND OF FOREIGN DIRECT INVESTMENT IN INDIA

A .Pre Reform Era

The process of planned economic development in India started with the launching of first five year plan on April1, 1951, although the foreign capital was regarded as effective ingredient of growth, the policy regarding FDI was rather selective. During the first five year plan a free flow of foreign capital was welcome because it was a necessity to ensure the supply of capital goods and technical knowhow (First Five Year Plan, GOI).Policy toward foreign investment made a U- turn during Third and Fourth Five year plan in view of severe constraints on foreign exchange reserves. By mid-1980s, the country started opening its economy by inviting foreign investments and liberalising its trade regime. Apart from giving direct incentives to the foreign direct investment. One form of such support was the creation of a tax structure conducive to direct and portfolio investments. Progress toward foreign direct investment in India was rather sluggish during1948-49 to 1989-90.

B .Post Reform Era

The average growth rate in the ten year period from 1992-93 to 2001-02 was around 6.0 percent. In sharp contrast, growth in the 1990s was accompanied by remarkable external stability despite the East Asian crisis. (Ahluwalia Montek S.2002). Annual inflow of foreign investment in India is presented in Table 1. It shows the comparative position of FDI and portfolio investment in India. In 2001-02 both these stood at US$ 6130million and US$2021 million respectively.

Table 1: Trends in Foreign Investment Flows in to India (In US$ million)

YEAR	FDI	PORTFOLIO INVESTMENT	TOTAL INVESTMENT FLOWS
1990-2000	2155	3026	5181
2000-2001	3270	2590	5680
2001-2002	6130	2021	8151
2002-2003	5035	979	6014
2003-2004	4322	11377	15699
2004-2005	3712	9292	13003
2005-2006	3769	12492	16261
2006-2007	7693	6947	14640
2007-2008	15891	27434	43325
2008-2009	22343	-14032	8311
2009-2010	17965	32396	50361
2010-2011	11305	30292	41593
2011-2012	22006	17171	39177
2012-2013	19819	26891	46710

Source – RBI, Bulletin, November 2015, Table No. 34, www.rbi.org.in

During 2007-08 both FDI and Portfolio investment stood at US$ 15891 million and US$ 27434 million respectively. Year 2008-09 witnessed historic economic recession in the world and in India too. BSE sensex decreased sharply and recorded below 10,000 from the highest level of 21,000. As a result portfolio investment witnessed outflow and it was US$ - 14032 million in 2008-09.Pace of growth of inflow of FDI and portfolio investment showed almost similar trends during 1999-00 to 2014-15. Higher trends were witnessed up to 2007-08. The sharp decline in portfolio investment during 2008-09 was the result of global meltdown. Portfolio inflow was – US$ 14032 million, however, net FDI inflows was US$ 22343 million. Gross FDI inflows during the 2008-09 were US$ 8311 million. Provisional data for 2014-15 shows FDI inflow at US$32628 million and Portfolio Investment at US$40934 million. The trends in FDI are being presented as growth model in the following manner

Section III

IMPACT OF FDI ONECONOMIC GROWTH

The positive impact of FDI is likely to be higher as value addition under FDI increases. In 2008-09 the FDI inflow and consequently the growth of the economy witnessed a downfall due to the global recession however the Indian economy witnessed a swift recovery in 2009-10. The global economic slowdown had affected the Indian

economy and GDP growth moderated to 6.8% in 2008-09 compared to an average of 9.5% in the preceding three years. The impact of global slowdown was more intense on industry, particularly the manufacturing sector. The fiscal and monetary policy interventions, however, provided the stimulus to the economy, leading to
a recovery in the GDP growth to 8.0% in 2009-10 and 8.9% in the first half of 2010-11(Economic Survey, 2010-11). In general terms, FDI inflow has a positive impact on the growth of GDP in India. Table 2 reveals that FDI inflow increased during 1999-00 to 2013-14 despite some serious fluctuations. GDP has increased by about three times during the same period. An econometric model is being put forward to quantitatively prove the relationship between GDP growth and FDI inflow.

Table 2: Trends of Growth Rate of GDP and FDI Inflow

Year	FDI Inflow		GDP at factor cost	
	Rs. crore	% change	Rs. crore	% change
1999-00	22450	22.2552	2023130	12.1855762
2000-01	10733	-52.1915	2177413	7.62595582
2001-02	18654	73.80043	2355845	8.19467873
2002-03	12871	-31.0014	2536327	7.66103033
2003-04	10064	-21.8087	2841503	12.0322025
2004-05	14653	45.59817	3242209	14.1019031
2005-06	24584	67.77452	3693369	13.9152041
2006-07	56390	129.3768	4294706	16.2815305
2007-08	98642	74.92818	4987090	16.1218021
2008-09	142829	44.79532	5630063	12.8927491
2009-10	123120	-13.799	6477827	15.0578066
2010-11	97320	-20.9552	7784115	20.1655277
2011-12	165146	69.69379	8832012	13.4619928
2012-13	121907	-26.1823	9988540	13.0947286
2013-14	147518	21.00864	11345056	13.5807235

Source: (i) RBI, (ii) SIA, Newsletter & Economic Survey 2014-15

SECTION IV

Foreign Direct Investment policy since 1991:

Foreign direct investment policy of the government of India has been gradually liberalized. As early as in the year 1948 and 1956 (two industrial policy resolutions) government policy clearly reflected the need to supplement foreign capital and technology for rapid economic growth. The core objective of the foreign capital policy was that the control of industrial undertaking should remain in the Indian hands. However, the government had granted permission in certain cases for allowing establishment of exclusive foreign enterprises. Foreign capital was preferred in specific areas which bring in new technology and establish joint ventures with Indian partners. Government also granted tax concessions to foreign enterprises and streamlined industrial licensing procedures to accord early approvals for foreign collaborations. In the case of 100 per cent export of output, foreigners were allowed to establish industrial units. It needs to be noted here that under the Foreign Exchange Regulation Act (FERA) 1974 only up to 40 per cent of the equity holding of the foreign firms were permitted. Foreign investment was permitted under designated industries along with restrictions in terms of local content clauses, export obligations, promotion of R&D and prohibition by law the use of foreign brands (Hybrid domestic brands were promoted such as Ford Escort and Hero Honda). It needs to be pointed out here that the restrictions have been flouted frequently and relaxations were also granted. This process has culminated into gradual liberalization of government policy towards foreign capital. It is reflected in continuous increase in the number of approvals granted. During the period 1961-1971, the number of foreign collaborations approved was 2475 which were increased to 3041 during the period 1971- 1980. There was dramatic increase in the foreign collaboration approvals during the period 1981-1990

(7436 collaborations were approved). This policy enabled to build domestic technological capability in many branches of industry but generally considered 8 very restrictive. It has been widely accepted that protection of domestic industry for a longer period of time resulted into high cost production structure along with poor quality. Foreign direct investment policy announced by the government of India in July 1991 was regarded as a dramatic departure from the earlier restrictive and discretionary policy towards foreign capital. The FDI policy of 1991 proposed to achieve objective of efficient and competitive world class Indian industry. Foreign investment was seen as a source of scarce resource, technology and managerial and marketing skills. The major feature of policy regarding foreign investment up to 51 per cent of equity holding was too permitted. Automatic approvals were also allowed to foreign investment up to 51 per cent equity in 34 industries as well as to foreign technology agreements in high priority industries. The Foreign Investment Promotion Board (FIPB) was set up to speedily process applications for approvals of the cases which were not covered under the automatic route. Laws were amended to provide foreign firms the equivalent status as the domestic ones. Government of India, however, put in place the regulatory mechanism to repatriate payments of dividends through Reserve Bank of India so that outflows are balanced through export earnings during stipulated period of time. Further liberalization measures with regard to foreign investment were taken during 1992-93. The dividend balance conditions were revoked except in the case of consumer goods industries. Non Resident Indian (NRI) and Overseas Corporate Bodies (OCB) were permitted in high priority industries to invest up to 100 per cent equity along with repatriation of capital and income. Apart from expansion of the area of operation for FDI in many new economic activities, the existing companies were also allowed to increase equity participation up to 51 per cent along with disinvestment of equity. Foreign direct investment policy has been changed frequently since 1991 to make it more transparent and attractive to the foreign investors. FDI up to 100 per cent is allowed under automatic route for all sectors/activities except activities that attract industrial licensing, proposals where foreign investors had an existing joint venture in same field, proposals for acquisition of shares in an existing Indian company in the financial sector and those activities where automatic route is not available. The only sectors/activities where FDI is not permitted are agriculture and plantations excluding tea plantations, real estate business (excluding development of townships, housing, built up infrastructure and construction development projects-NRI/OCB investment is allowed for the real estate business), retail trade, lottery, security services and atomic energy. Government has simplified procedure, rules and regulations on a regular basis since 1991 to make Indian economic environment foreign investor friendly.7 Attempt has been made through FDI policy to make India the hub of global foreign direct investment as well as in economic activities.

CONCLUSION

If India has to achieve its desired goals as laid down in the twelfth Five Year Plan then our economy has to be strong and vibrant and the result of development equitably shared. The results of second generation economic reforms would be realised only if suitable changes in institutional apparatus and organisations are implemented both at the Central and State levels for attracting FDI inflows. The economic reforms in India have been instrumental in breaking the Hindu rate of growth of 3.5 per cent and moving towards faster economic growth. Increase in FDI inflow has been one of the major achievements in the post reforms period, however its benefits
have not been interstate and intra state variations evenly spread across the entire economy and there are large. The trend of FDI inflow as projected by the semi log linear model shows a steady increase in FDI inflow in the coming years. This inflow if used judiciously and support by infrastructural development could have the way for fast economic growth in the country.
Thus, it can be concluded that although attracting FDI can be an important factor for development, however, it is not an end in itself. The right strategy would be to create a favourable environment throughout the country for equitable FDI inflow and simultaneously develop sound domestic macro-economic and structural policies.

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