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Analysis of Foreign Direct Investment on Indian Economy

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ABSTRACT:
One of the most striking developments during the last two decades is the spectacular growth of (Foreign Direct Investment) FDI in the global economic landscape. This unprecedented growth of global FDI in 1990 around the world make FDI an important and vital component of development strategy in both developed and developing nations and policies are designed in order to stimulate inward flows. Infact, FDI provides a win – win situation to the host and the home countries. Both countries are directly interested in inviting FDI, because they benefit a lot from such type of investment. The 'home' countries want to take the advantage of the vast markets opened by industrial growth. On the other hand the 'host' countries want to acquire technological and managerial skills and supplement domestic savings and foreign exchange. Moreover, the paucity of all types of resources viz. financial, capital, entrepreneurship, technological know- how, skills and practices, access to markets- abroad- in their economic development, developing nations accepted FDI as a sole visible panacea for all their scarcities. Further, the integration of global financial markets paves ways to this explosive growth of FDI around the globe

KEY WORDS*:* Foreign Direct Investment, financial, capital, entrepreneurship

INTRODUCTION:

The historical background of FDI in India can be traced back with the establishment of East India Company of Britain. British capital came to India during the colonial era of Britain in India. However, researchers could not portray the complete history of FDI pouring in India due to lack of abundant and authentic data. Before independence major amount of FDI came from the British companies. British companies setup their units in mining sector and in those sectors that suits their own economic and business interest. After Second World War, Japanese companies entered Indian market and enhanced their trade with India, yet U.K. remained the most dominant investor in India.

Further, after Independence issues relating to foreign capital, operations of MNCs, gained attention of the policy makers. Keeping in mind the national interests the policy makers designed the FDI policy which aims FDI as a medium for acquiring advanced technology and to mobilize foreign exchange resources. The first Prime Minister of India considered foreign investment as "necessary" not only to supplement domestic capital but also to secure scientific, technical, and industrial knowledge and capital equipments. With time and as per economic and political regimes there have been changes in the FDI policy too. The industrial policy of 1965, allowed MNCs to venture through technical collaboration in India. However, the country faced two severe crisis in the form of foreign exchange and financial resource mobilization during the second five year plan (1956 -61). Therefore, the government adopted a liberal attitude by allowing more frequent equity participation to foreign enterprises, and to accept equity capital in technical collaborations. The government also provides many incentives such as tax concessions, simplification of licensing procedures and de- reserving some industries such as drugs, aluminium, heavy electrical equipments, fertilizers, etc in order to further boost the FDI inflows in the country. This liberal attitude of government towards foreign

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capital lures investors from other advanced countries like USA, Japan, and Germany, etc. But due to significant outflow of foreign reserves in the form of remittances of dividends, profits, royalties etc, the government has to adopt stringent foreign policy in 1970s. During this period the government adopted a selective and highly restrictive foreign policy as far as foreign capital, type of FDI and ownerships of foreign companies was concerned. Government setup Foreign Investment Board and enacted Foreign Exchange Regulation Act in order to regulate flow of foreign capital and FDI flow to India. The soaring oil prices continued low exports and deterioration in Balance of Payment position during 1980s forced the government to make necessary changes in the foreign policy. It is during this period the government encourages FDI, allow MNCs to operate in India. Thus, resulting in the partial liberalization of Indian Economy. The government introduces reforms in the industrial sector, aimed at increasing competency, efficiency and growth in industry through a stable, pragmatic and non-discriminatory policy for FDI flow.

FOREIGN DIRECT INVESTMENT IN INDIA: FDI AND ECONOMIC:

Growth The historical background of FDI in India can be traced back with the establishment of East India Company of Britain. British capital came to India during the colonial era of Britain in India. After Second World War, Japanese companies entered Indian market and enhanced their trade with India, yet U.K. remained the most dominant investor in India. Further, after Independence issues relating to foreign capital, operations of MNCs, gained attention of the policy makers. Keeping in mind the national interests the policy makers designed the FDI policy which aims FDI as a medium for acquiring advanced technology and to mobilize foreign exchange resources. With time and as per economic and political regimes there have been changes in the FDI policy too. The industrial policy of 1965, allowed MNCs to venture through technical collaboration in India. Therefore, the government adopted a liberal attitude by allowing more frequent equity. In the critical face of Indian economy the government of India with the help of World Bank and IMF introduced the macro-economic stabilization and structural adjustment program. As a result of these reforms India open its door to FDI inflows and adopted a more liberal foreign policy in order to restore the confidence of foreign investors. Further, under the new foreign investment policy Government of India constituted FIPB (Foreign Investment Promotion Board) whose main function was to invite and facilitate foreign investment Starting from a baseline of less than USD 1 billion in 1990, a recent UNCTAD survey projected India as the second most important FDI destination (after China) for transnational corporations during 2010-2012. As per the data, the sectors which attracted higher inflows were services, telecommunication, construction activities and computer software and hardware. Mauritius, Singapore, the US and the UK were among the leading sources of FDI to the country.

According to GYANPRATHA – ACCMAN (Journal of Management, Volume 5 Issue 1, 2013) FDI for 2009-10 at US$ 25.88 billion was lower by five per cent from US$ 27.33 billion in the previous fiscal. Foreign direct investment in August dipped by about 60 per cent to approx. US$ 34 billion, the lowest in 2010 fiscal, industry department data released showed. In the first two months of 2010-11 fiscal. FDI inflow into India was at an all-time high of $7.78 billion up 77%from $4.4 billion during the corresponding period in the previous year. In 2013, the government relaxed FDI norms in several sectors, including telecom, defence, PSU oil refineries, power exchanges and stock exchanges, among others. In retail, UK-based Tesco submitted its application to initially invest US$ 110 million to start a supermarket chain in collaboration with Tata Group's Trent. In civil aviation, Malaysia-based Air Asia and Singapore Airlines teamed up with Tata Group to launch two new airline services. Also, Abu Dhabi-based Etihad picked up a 24 per cent stake in Jet Airways that was worth over Rs 2, 000 crore (US$ 319.39 million).
India has received total foreign investment of US$ 306.88 billion since 2000 with 94 per cent of the amount coming during the last nine years. In the period 1999–2004, India received US$ 19.52 billion of foreign

investment. In the period 2004–09, foreign investment in the country touched US$ 114.55 billion, further increasing to US$ 172.82 billion between 2009–September, 2013. During FY 2012–13, India attracted FDI worth US$ 22.42 billion. Tourism, pharmaceuticals, services, chemicals and construction were among the biggest beneficiaries. The January–November period in 2013 witnessed mergers and acquisitions deals worth US $ 26.76 billion in India, according to a survey by tax advisory firm Grant Thornton.

VOLATILITY OF CAPITAL FLOWS:

India's attitude towards liberalisation of the capital account was strongly motivated by certain priors about the volatility of capital flows, and about the extent to which different kinds of capital flows would impinge upon the exchange rate. There has been disagreement about the volatility of the various kinds of capital flows, and the interplay between the currency regime adopted and the volatility of certain kinds of capital flows.

We can use quarterly balance of payments data in order to review India's experience with volatility of the four components of capital flows. The four components are foreign direct investment, foreign portfolio investment, debt and official flows. Debt is composed of commercial borrowings, short term loans and banking capital. Official flows are the sum of external assistance, rupee debt service and IMF related monetary movements. The focus of our analysis is the post-reform period. Table-1 shows the summary statistics about the four components of net capital flows, using data for 72 quarters from the Q1/1991 to Q4/2008. Since the data often has unusual distributional characteristics, the inter- quartile range is used as a relatively nonparametric measure of dispersion

TABLE-1

VOLATILITY OF CAPITAL FLOWS:
Summary Statistics of Quarterly Data from Q1 1991 to Q4 2014 (US $ Million)

Data	Minimum	Median	Maximum	Inter-quartile Range
FDI	7	899	14334	1314
FPI	-5786	594	12627	1340
Debt	-5399	826	16843	3018
Official Flow	-4858	2470	31520	3896

Source: Yearly Report on Foreign Exchange Reserves, 2013-14

The data shows that a net outflow was never observed in the case of FDI. FDI and portfolio flows have similar values for the inter-quartile range. Official flows have the highest value for the inter-quartile range followed by debt flows. Thus our analysis shows that FDI flows are highly stable, and more stable than other components. Official flows are highly unstable. The ranking of volatility of the four components of capital flows appears to be Official Flows > Debt Flows > F PI > FDI.

The results for the volatility of India's FDI and FPI flows appear to be more meaningful, since they reflect the outcomes obtained under a broadly stable policy framework, subject to a steady process of liberalisation whereby controls have been slowly relaxed over the years with an essentially one-way direction of reforms.

Over this period, fluctuations in official flows and debt frequently reflected changes in the policy framework. Capital controls and other policy levers were regularly used to encourage or discourage official flows and debt, depending on the tactical exigencies of implementing the currency peg. On some occasions, offshore borrowing was effectively initiated by the government, and banks were encouraged to borrow abroad at high rates. At other times, strict controls have been placed on offshore borrowing, and the interest rate at which banks borrow has been cut. The volatility of official flows and of debt flows might have been very different if India's policies on capital controls had been stable, or if the currency regime had been different.

FOREIGN INVESTMENT AND FOREIGN EXCHANGE RESERVES:

Foreign exchange reserves are external assets that are readily available to and controlled by monetary authorities for direct financing of external payments imbalances, for indirectly regulating the magnitudes of such imbalances through intervention in exchange markets to affect the currency exchange rate, and/or for other purposes. (*Balance of Payments Manual* and *Guidelines on Foreign Exchange Reserve Management: IMF*). Foreign exchange reserves include foreign currency assets, gold held by the RBI, reserve position in the IMF and holdings of Special Drawing Rights (SDRs). Although both US dollar and Euro are intervention currencies, the foreign exchange reserves are denominated and expressed in US dollar only. RBI functions as the custodian and manager of foreign exchange reserves and operates within the overall policy framework agreed upon with Government of India.The main objectives in managing a stock of reserves are preserving the long term value in terms of purchasing power over goods and services and minimizing risk and volatility in returns. After the East Asian crises of 1997, India has followed a policy to build higher levels of foreign exchange reserves that take into account not only anticipated current account deficits but also liquidity at risk arising from unanticipated capital movements. Accordingly, the primary objectives of maintaining foreign exchange reserves in India are safety and liquidity; maximising returns is considered secondary.As the objectives of reserve management are liquidity and safety, attention is paid to the currency composition and duration of investment, so that a significant proportion can be converted into cash at short notice. The essential framework for investment is conservative and is provided by the RBI Act, 1934, which requires that investments be made in foreign government securities (with maturity not exceeding 10 years), and that deposits be placed with other central banks, international commercial banks, and the Bank for International Settlements, following a multi-currency and multi-market approach. A small component of reserves is also placed with external asset managers to access their market research and help the RBI staff to acquire adequate skills in reserve management. The conservative strategy adopted in the management of foreign exchange reserves has implications for the rate of return on investment. The direct financial return on holdings of foreign currency assets is low, given the low interest rates prevailing in the international markets. However, the low returns on foreign investment have to be compared with the costs involved in reviving international confidence once eroded, and with the benefits of retaining confidence of the domestic and international markets, including that of the credit rating agencies.

India followed a restrictive external sector policy until 1991, mainly designed to conserve limited foreign exchange reserves for essential imports (petroleum products and food grains), restrict capital mobility, and discourage entry of multinationals. As a result of measures initiated to liberalise capital inflows, India's foreign exchange reserves (mainly foreign currency assets) increased from US $ 5.8 billion at end-March 1991 to US $ 252 billion at end March 2014. The acceleration in the trend first emerged in 1993, as recorded by the rise in foreign currency assets, when India adopted the market-based system of exchange rates, and then in 2001 when the current account recorded a surplus after a persistent deficit since 1978. The traditional measure of trade based indicator of reserve adequacy, i e, the import cover (defined as the 12 times the ratio of reserves to merchandise imports) which shrank to three weeks of imports by the end of December 1990, has improved to more than 16 months as at end-March 2004 which then declined to 10 months at the end of March 2014. The debt- service ratio declined from 35.3 per cent in 1990-91 to 4.6 per cent by end March 2014.

In India, almost the whole of addition to reserves in the last few years has been made while keeping the overall level of external debt (measured by debt stock-GDP ratio) almost constant. Two factors are responsible for significant addition to foreign exchange reserves in the recent past: (a) a far lower level of current account deficit than the expected sustainable level of about 2 per cent of Gross Domestic Product each year and (b) a continued inflow of capital especially of non-debt creating flows as more or less planned.
An attempt is made in the following section to analyse the contribution of foreign investment to India's foreign exchange reserves. The main sources of foreign exchange reserves in India are inflows of foreign investment, external commercial borrowings and deposits by non-resident Indians. During 1991-92 to 2013-14 foreign investment contributed 61.59 per cent to the accretion in foreign exchange reserves. The contribution of portfolio investment was 31.51 per cent while FDI contributed 30.08 per cent.External commercial borrowings contributed 27.06 per cent while that of NRI deposits was 13.53 per cent. The sources of foreign exchange reserves since 1991 are presented in Table-2.

TABLE-2

SOURCES OF ACCRETION TO FOREX RESERVES SINCE 1991 to 2014:

S. No.	ITEMS	1991-92 to 2013-14
1	Outstanding Reserves as on end March 1991	5.8 (2.30)
2	Current Account Balance	-81.6 (-32.38)
3	Capital Account (net) (a to e)	331.7 (131.63)
4	Foreign Investment of which: (1) FDI (2) FPI NRI Deposits External Assistance External Commercial Borrowings Other items in Capital Account	155.2 (61.59) 75.8 (30.08) 79.4 (31.51) 34.1 (13.53) 18.6 (7.38) 68.2 (27.06) 55.6 (22.06)
5	Valuation Change	-4.0 (-1.59)

Source: Yearly Report on Foreign Exchange Reserves, 2013-14

FOREIGN INVESTMENT AND FOREIGN EXCHANGE RATE:

Now we turn to analyse the behaviour of the rupee in the foreign exchange markets in the post reform period. In the case of India, exchange rate was fixed by the central bank for a long period of time. Between 1991 and 1993 there existed a system when only a portion of export earnings could be converted into the domestic currency at the market determined exchange rate. After January 1993 the exchange rate became fully '*market determined*'. However, it was kept constant for a long period by the central bank intervention in the foreign exchange market.
In the following section we briefly look at the exchange rate regime in India, recent trends in the rupee-dollar

nominal exchange rate and the nominal and real effective exchange rates. The movement towards market determined exchange rates in India began with the official devaluation of the rupee in July 1991. The rupee was devalued against the dollar by 9 per cent and 11 per cent on July 1 and 3, 1991 as a measure to counter the massive drawdown in the foreign exchange reserves, to instill confidence among investors and to improve domestic competitiveness. In March 1992 a dual exchange rate system was introduced in the form of the Liberalized Exchange Rate Management System (LERMS). Under this system all foreign exchange receipts on current account transactions were required to be submitted to the Authorized Dealers of foreign exchange in full. The rate of exchange for conversion of 60 per cent of the proceeds of these transactions was the market rate quoted by the Authorized Dealers. The balance 40 per cent was to be surrendered to the RBI at the official exchange rate announced by RBI. As the exchange rate aligned itself with market forces, the rupee-dollar rate depreciated steadily from 25.83 in March 1992 to 32.65 in February 1993. The LERMS was essentially a transitional mechanism and ultimate convergence of the dual rates was made effective from March 1, 1993, leading to the introduction of a single, market-determined exchange rate regime.

With the liberalization in the capital account in the area of foreign direct investment and portfolio investments, capital inflows surged during 1993-94 and 1994-95. The large inflows tended to exert appreciating pressure on the rupee. However, the rupee was not allowed to appreciate but was kept constant by the RBI for the fear that any nominal appreciation of the rupee could have eroded India's export competitiveness. The market was not freely allowed to determine the exchange rate of the rupee. If it had, the rupee would have appreciated. As a result of the intervention by the RBI in the foreign exchange market, the exchange rate of the rupee remained almost stable at Rs.31.37 per US dollar from March 1993 to July 1995. All through the nineties, the rupee was depreciating against the dollar as shown by the consistent minus signs in Table-3. The Table gives yearly changes, but reversals can occur within a year while the one way trend continues.

TABLE-3

TRENDS IN THE NOMINAL EXCHANGE RATE:

Year	Average Exchange Rate (Rs. per US $)	Appreciation (+) Depreciation (-) (Per Cent)	Coefficient of Variation	Standard Deviation
1993-94	31.37	-2.30	0.1	0.03
1994-95	31.40	-0.10	0.3	0.09
1995-96	33.45	-6.13	5.8	1.93
1996-97	35.50	-5.78	1.3	0.48
1997-98	37.16	-4.47	4.2	1.57
1998-99	42.07	-11.67	2.1	0.90
1999-00	43.33	-2.91	0.7	0.29
2000-01	45.68	-5.14	2.3	1.07
2001-02	47.69	-4.21	1.4	0.67
2002-03	48.40	-1.47	0.9	0.45
2003-04	45.95	+ 5.33	1.6	0.72
2004-05	44.93	+ 2.27	2.3	1.03
2005-06	44.27	+ 1.49	1.5	1.79
2006-07	45.28	-2.23	2.0	0.89
2007-08	40.24	+ 12.52	1.96	0.79

2008-09	45.92	-12.37	1.95	0.90
2009-10	45.23	-11.98	1.76	0.79
2010-11	45.67	-11.99	2.01	0.86
2011-12	44.87	-11.12	1.42	0.84
2012-13	45.03	-12.01	1.98	0.94
2013-14	46.25	-12.22	2.01	1.08

Calculated with RBI data, 2013-14

CONCLUION:

Conclusion India's Foreign Direct Investment (FDI) policy has been gradually liberalised to make the market more investor friendly. The results have been encouraging. These days, the country is consistently ranked among the top three global investment destinations by all international bodies, including the World Bank, according to a United Nations (UN) report. For Indian economy which has tremendous potential, FDI has had a positive impact. FDI inflow supplements domestic capital, as well as technology and skills of existing companies. It also helps to establish new companies. All of these contribute to economic growth of the Indian Economy.

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