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FDI in India and Its Effects on Capital Flow

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1. INTRODUCTION

Foreign direct investment (FDI) is investment directly into production in a country by a company located in another country, either by buying a company in the target country or by expanding operations of an existing business in that country. It is cross border investment, where foreign assets are invested into the organizations of the domestic market excluding the investment in stock. FDI refers to the net inflows of investment (inflow minus outflow) to acquire a lasting management interest (10 per cent or more of voting stock) in an enterprise operating in an economy other than that of the investor. It usually involves participation in management, joint-venture, transfer of technology and expertise. It brings private funds from overseas into products or services. The domestic company in which foreign currency is invested is usually being controlled by the investing foreign company. Foreign direct investment (FDI) plays an extraordinary and growing role in global business. It can provide a firm with new markets and marketing channels, cheaper production facilities, access to new technology, products, skills and financing.

2. IMPORTANCE OF FDI

Why is FDI important for any consideration of going global?

The simple answer is that making a direct foreign investment allows companies to accomplish several tasks:

- Avoiding foreign government pressure for local production.
- Circumventing trade barriers, hidden and otherwise
- Making the move from domestic export sales to a locally based national sales office.
- Capability to increase total production capacity.
- Opportunities for co-production, joint ventures with local partners, joint marketing arrangements, licensing, etc.;

BENEFITS OF FDI TO HOST NATION:

For a host country or the foreign firm which receives the investment, it can provide a source of new technologies, capital, processes, products, organizational technologies and management skills, and as such can provide a strong impetus to economic development.

3. MEANING

Foreign direct investment (FDI) is direct investment by a company in production located in another country either by buying a company in the country or by expanding operations of an existing business in the country. Foreign direct investment is done for many reasons including to take advantage of cheaper wages in the country, special investment privileges such as tax exemptions offered by the country as an incentive to gain tariff-free access to the markets of the country or the region.

OBJECTIVE:

To understand the concept and trends of FDI.

4. FDI IN INDIA

Foreign Direct Investment (FDI) in India is undertaken in accordance with the FDI policy formulated and announced by the Government of India and is governed by the provisions of Foreign Exchange Management Act, 1999.

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 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 resource.

The Ernst & Young's 2012 India Attractiveness Survey says investors view India as an attractive investment destination. In the survey's global ranking, India is the fourth destination for foreign direct investment (FDI) just below the United States, China and Britain. China is the largest competitor of India in terms of attractiveness, according to the survey.

Generally speaking FDI refers to capital inflows from abroad that invest in the production capacity of the economy and are "usually preferred over other forms of external finance because they are non-debt creating, non-volatile and their returns depend on the performance of the projects financed by the investors. FDI also facilitates international trade and transfer of knowledge, skills and technology."

It is furthermore described as a source of economic development, modernization, and employment generation, whereby the overall benefits (dependant on the policies of the host government)…triggers technology spill-over, assists human capital formation, contributes to international trade integration and particularly exports, helps create a more competitive business environment, enhances enterprise development, increases total factor productivity and, more generally, improves the efficiency of resource use.

Changes in the national political climate have precipitated a marked trend towards greater acceptability of FDI. The envisioned role of FDI has evolved from that of a tool to solve the crisis under the license raj system to that of a modernising force that has been given special agencies and extensive discourse. This evolution is illustrated by analysis of the Economic policies of the Indian government from 1991 to 2005. The primary focus of this analysis will be towards the industrial and infrastructural sectors which form the beginning of the gradual liberalization process that was started in 1991.

Now days, there is hardly a facet of the Indian psyche that the concept of 'foreign' has not permeated. This term, connoting modernization, international brands and acquisitions by MNCs in popular imagination, has acquired renewed significance after the reforms initiated by the Indian Government in 1991. Contrary to the grand narrative 'opening of flood-gates idea' of 1991, what took place was a gradual process of changes in policies on investment in certain sub-sections of the Indian economy

1. ENTRY ROUTES FOR INVESTMENT IN INDIA:

Under the Foreign Direct Investments (FDI) Scheme, investments can be made in shares, mandatorily fully convertible debentures and mandatorily fully convertible preference shares of an Indian company by non-residents through two routes:

AUTOMATIC ROUTE:

FDI up to 100 per cent is allowed under the automatic route in all activities/sectors except where the provisions of the consolidated FDI Policy on 'Entry Routes for Investment' are attracted. FDI in sectors /activities to the extent permitted under the automatic route does not require any prior approval either of the Government or the Reserve Bank of India.

GOVERNMENT ROUTE:

FDI in activities not covered under the automatic route requires prior approval of the Government which is considered by the FIPB, Department of Economic Affairs, Ministry of Finance. Indian companies having foreign investment approval through FIPB route do not require any further clearance from the RBI for receiving inward remittance and for the issue of shares to the non-resident investors.

2. ELIGIBILITY FOR INVESTMENT IN INDIA:

Person Resident or Entity Incorporated Outside India:

- Other than a citizen of or Entity incorporate d in Pakistan
- Person /Entity in Bangladesh requires prior FIPB approval

NRIs in/Citizen of Nepal and Bhutan:

- Can invest on Repartition basis
- Amount of consideration for investment to be in free foreign exchange only
- Overseas Corporate Bodies (OCBs) de-recognised w.e.f Sep 16,2003

3. PROHIBITION ON FDI IN INDIA:

Foreign investment in any form is prohibited in a company or a partnership firm or a proprietary concern or any entity, whether incorporated or not (such as, Trusts) which is engaged or proposes to engage in the following activities:

FDI is prohibited under the Government Route as well as the Automatic Route in the following sectors:

(1) Atomic Energy

(2) Lottery Business

(3) Gambling and Betting

(4) Business of Chit Fund

(5) Nidhi Company

(6) Agricultural (excluding Floriculture, Horticulture, Development of seeds, Animal Husbandry, Pisiculture and cultivation of vegetables, mushrooms, etc. under controlled conditions and services related to agro and allied sectors) and Plantations activities (other than Tea Plantations)

(7) Housing and Real Estate business (except development of townships, construction of residential/commercial premises, roads or bridges).

(8) Trading in Transferable Development Rights (TDRs).

(9) Manufacture of cigars, cheroots, cigarillos and cigarettes, of tobacco or of tobacco substitutes.

3. SECTOR SPECIFIC CONDITIONS

I. Prohibited sectors:

II. Permitted sectors:

In the following sectors/activities, FDI up to the limit indicated against each sector/activity is allowed and in sectors/activities not listed below, FDI is permitted up to 100% on the automatic route, subject to applicable laws/ regulations; security and other conditionality.

Sectors/Activities falling under Government Route with percentage of FDI permitted:

Upto 26 %	Upto 49 %	Upto 74 % (Automatic upto 49%)	Upto 100 %
•Defence Industry subject to Industrial license under the IDRA •Terrestrial Broadcasting FM (FM Radio) •Up-linking a News & Current Affairs TV Channel •Publishing of Newspaper and periodicals dealing with news and current affairs •Publication of Indian editions of foreign magazines dealing with news and current affairs •Banking- Public Sector (up to 20% only)	•Petroleum refining by PSU without any disinvestment or dilution of domestic equity in the existing PSUs. •Cable Network & DTH (FDI component not to exceed 20%) •Setting up of Up-linking HUB/ Teleports •Private Security Agencies •Commodity exchange •Credit Information Companies •Infrastructure Company in the Securities Market •Financial Services ARC (49% of paid up capital of ARC)	•Headend-In-The-Sky (HITS) Broadcasting Service •Non-Scheduled Air Transport Service •Ground Handling Services •Satellites – Establishment and operation, subject to the sectoral guidelines of Department of Space/ISRO •Telecom services •Internet Service Providers with/without gateways, radip paging, end to end bandwith •Banking –Private sector	•Mining and mineral separation of titanium bearing minerals and ores, •Up-linking a Non-News & Current Affairs TV Channel •Publishing/printing of Scientific and Technical Magazines/specialty journals/ periodicals •Publication of fax edition of foreign newspapers •Airports - Exisiting Project •Courier services •Tea Plantation •Financial Services •Test Marketing •Infrastructure provider (dark fibre, right of way, duct space, tower, electronic, voice mail)

Source: Internet

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4. DETERMINANTS OF FOREIGN DIRECT INVESTMENT IN INDIA

The determinants of the FDI are numerous. Whether particular action ofinvestor or government is responsible for increase or decrease in the investment for agiven period is treated as determinant. There is not a single variable which would influence investment to rise or fall but it is comprised of a set of variables. It would be very valuable to review the key determinants and factors of FDI based on the theories of international investment.

The FDI theories are categorized into two parts in order to know the Theoretical determinants of FDI. (a) Theories based on Perfect and (b) Theories based on Imperfect market. The perfect market assumes that there exists competition for investment, equal opportunity, and there is equal return on investment across the countries. Perfect competition within the industries implies that there are numerous firms manufacturing same items of same quality and all industries have equal rate of return and tax rate. According to imperfect theory, the financial markets are never perfect. The information needed to take rational decision is rarely available. The risk associated with different level of investment also differs. The investment schedule of the investing firm depends upon rate of return in imperfect market. The industrial organizations across the world are neither identical nor face same problems at a same time.

A) Theories based on Perfect Markets:

- Differential Rate of Return
- Portfolio Diversification
- Market Size
- Resource Location

B) Theories Based on Imperfect Market:

- Industrial Organization
- Internationalization
- Liquidity
- Foreign Exchange Rate
- Political Stability
- Tax Policies
- Government Regulations
- Trade Policy

5. IMPACT OF DETERMINANTS ON FDI

DETERMINANT S	IMPACT
Market Size (GDP)	GDP growth is proxy for potential market size for sales, which in turn determines flow of FDI
Portfolio Diversification	Expected risk and retur n determines the flow of FDI
Resource Location	FDI flows will be adversely affected if the natural resources are highly protected
Differential Rate of Return	FDI flows from low to high rate return region
Foreign Exchange Reserves	More Reserves has positive impact on FDI
Internationalization	FDI is result of firms replacing transaction cost with Internationalization
Openness	More open econom y to outside external trade can attract more FDI.
Government Regulations	Favourable regulations make the FDI to occur
Political Stability	Political, economic and social stability makes FDI to occur and instability deter FDI
Tax Policies	Tax affects net return on investment therefore tax system determines FDI.
Industrial Organization	Structural imperfection determines the FDI flows
The Level of External Indebtedness	M ore burden of repayment and debt servicing making the country less attractive for foreign investor
Foreign Exchange Rate	Relative strength of currency determines the FDI flow
Inflation	Low inflation rate is considered better over high inflation rate as it indicates internal economic stability of the host country.

6. EXPECTED THEORETICAL RELATIONSHIP BETWEEN FDI AND ITS DETERMINANTS

There are so many determinants of FDI in the economy as suggested by existing literature available on this issue. There is need to know the expected relation between FDI and these determinants before doing empirical investigation regard in relationship of FDI and some variables taken in this study so as to find main determinants of FDI in India.

(I) MARKET SIZE:

Market size which is measured in terms of GDP is expected to have positive relationship with FDI. Countries having more GDP growth rate can attract more FDI inflows. Market oriented FDI aims to set up enterprises to supply goods and services to the local market. This kind of FDI may be undertaken to exploit new markets. The market size of host countries is very important location factor for market oriented FDI. The general implication is that host countries with larger market size, faster economic growth and higher degree of economic development will provide more and better opportunities for these industries to exploit their ownership advantages and therefore, will attract more market-oriented FDI. Even for export-oriented FDI, the market size of host countries is an important factor because larger economies can provide larger economies of scale and spill-over effects.

(ii) PORTFOLIO DIVERSIFICATION:

The diversification of portfolio is also considered to be another determinant. The approximate mix of bonds, securities, stock, debenture, depository receipts, etc. refers to portfolio investment. The maturity of these instruments may vary from few months to few years. The concern of an investor is for these instruments at a time of risk perceptions. It implies that the investors are able to invest in or take out their capital for diversification of their portfolio assets due to perceived risk in a country. The higher is the perceived country risk due to political, economic and financial changes in one country; an investor would like to take out his capital out of the country.

(iii) RESOURCE LOCATION:

Location- specific determinants have a crucial influence on a host country's inflow of FDI. The relative importance of different location-specific determinants depends on at least three aspects of investment:

(1) The motive for investment (e.g., resources, market or efficiency-seeking),

(2) The type of investment (e.g., services or manufacturing), and

(3) The size of the investors (small and medium MNEs or large MNEs)

Natural resources protected from international competition by imposing high tariffs or quotas, still play an important role in attracting FDI by a number of developing and developed countries. The theoretical analysis concludes that policy related variables and economic determinants together explain the variations in the FDI inflows in country.

(iv) DIFFERENTIAL RATE OF RETURN:

This theory explains mostly the held belief that the FDI flows to that country which has relatively higher return on the investment. No investor would like to invest if the rate of return on investment is low. Therefore, the flow of capital will be in those countries which ensure the highest possible rate of return.

(v) FOREIGN EXCHANGE RESERVES:

The high level of foreign exchange reserves in terms of import cover reflects the strength of external payments position and help to improve the confidence of the prospective investors. Therefore, a positive relationship is postulated between the foreign exchange reserves and the inflow of foreign direct investment.

(vi) INTERNATIONALIZATION:

Internationalization refers to minimize or eliminate cost of external transaction by increasing transaction within subsidiaries. This theory explains that FDI is an outcome of need to lower the cost of transaction. In other words, need for internationalization of transaction cost determines the FDI inflows. The internationalization of transaction cost is achieved through FDI investment in subsidiary to eliminate high cost of transaction or replace high cost transaction through low cost when it is impossible to eliminate.

(vii) OPENNESS:

Openness of a country is generally measured as the proportion of exports and imports to the GDP (Trade/GDP). The more an emerging market tries to open its economy to outside external trade, the more this host country can attract FDI. Export oriented FDI depends upon liberal trade policies reflected in openness of the country as the TNC is not interested in market seeking behaviour initially and openness helps it in importing components, capital goods, and raw material.

(viii) GOVERNMENT REGULATIONS:

This consists of rules and regulations governing the entry and operations of foreign investors. FDI cannot take place unless it is allowed to enter in a country. Its potential relevance is evident when policy changes sharply in the direction of more or less openness. It should be noted, however that policy changes in the direction of openness differ in an important way from those in the direction of restriction. Open policies are basically intended to induce FDI while restrictive policies such as sweeping nationalization of foreign affiliates, can effectively close the door to FDI.

(ix) POLITICAL STABILITY:

The reliability and political stability determines the FDI inflows. TNCs prefer stable government so that their investment is protected. Political instability may be in the form of negative attitude of the government toward TNCs, non-allowance of fund transfer, currency convertibility, war, bureaucracy and corruption. Political stability can also be measured by number of changes of democratically elected governments.

(x) TAX POLICIES:

Fiscal policies determine general tax levels, including corporate and personnel tax rates and thereby influence inward FDI. Other things being equal a country with lower tax rates should stand a greater chance of attracting FDI project than a country with higher rates. It is difficult to ascertain how much influence it can have on the total inflows of FDI.

(xi) INFLATION:

Low inflation rate is considered to be a sign of internal economic stability in the host country. High inflation rate indicates incapability of the government to balance its budget and failure of the central bank to conduct appropriate monetary policy. Changes in inflation rates of the domestic or foreign country are anticipated to alter the net returns and optimal investment decisions of the MNEs. It is expected to give negative impact on FDI .

(xii) INDUSTRIAL ORGANIZATION:

Industrial organization theory states that firm specific advantages, competition capabilities, managerial skills and practice etc. are some of the crucial points for industrial organization to survive. There relative advantages to TNCs in terms of these points make FDI to flow to a country of their choice .

(xiii) THE LEVEL OF EXTERNAL INDEBTEDNESS:

The level of external indebtedness means the net external assistance to India in the form of loans. It is expected to have a negative impact on FDI inflows. The level of indebtedness shows the burden of repayment and debt servicing on the economy, thus making the country less attractive for foreign investors .

(xiv) FOREIGN EXCHANGE RATE:

It is the rate at which one currency may be converted into another. In other words it is the relative strength of the domestic country in relation to the foreign country. High volatility of the exchange rate of the currency in the host country discourages investment by the foreign firms as it increases uncertainty regarding the future economic and business prospects of the host country .

7. TRENDS

Inflow of Foreign Investment in India:

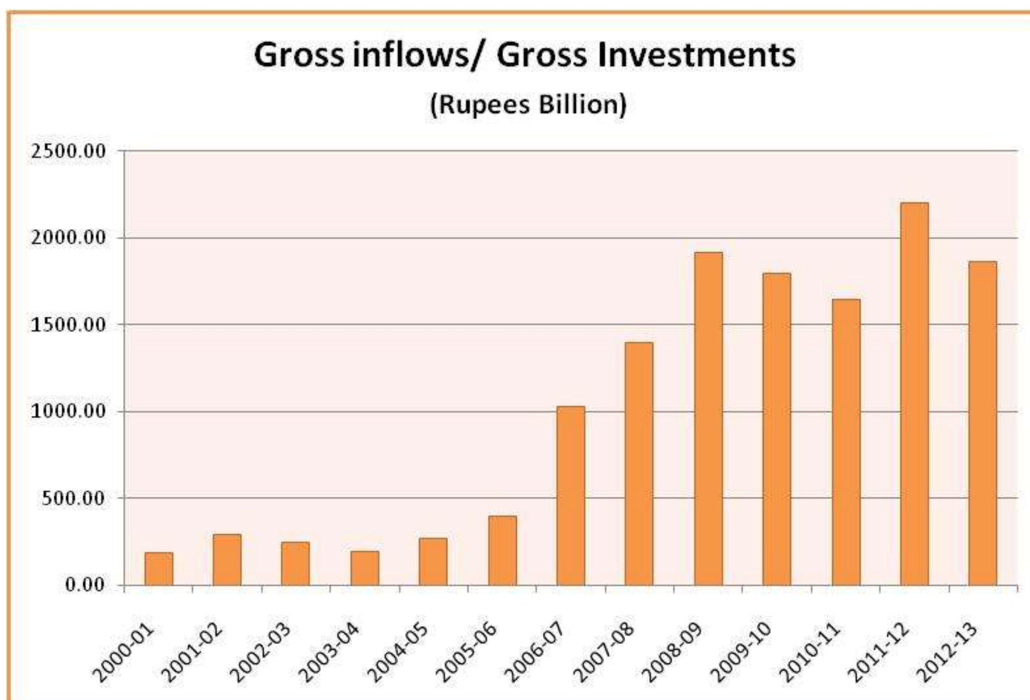
In India foreign capital comes from private individual and institutional investors on commercial terms in the form of Euro-issues comprising, external commercial borrowings, portfolio investments by non-resident of India's, overseas corporate bodies and investments by foreign financial institutions.

Following table shows the Gross inflow of foreign Investment in India since 2000 to 2013:

Year	Gross inflows/ Gross Investments (Rupees Billion)
2000-01	184.04
2001-02	292.69
2002-03	246.81
2003-04	198.30
2004-05	272.34
2005-06	397.30
2006-07	1030.37
2007-08	1398.84
2008-09	1914.00
2009-10	1796.00
2010-11	1643.00
2011-12	2198.54
2012-13	1864.98

Source: RBI

Here, by analysing the gross inflows we can say India is seen as an attractive destination for foreign investments. The attractiveness of India as a preferred investment destination could be ascertained from the large increase in FDI inflows to India, which rose from around 300 billion in 2001-02 to almost 1900 billion in 2008-09. The significant increase in FDI inflows to India reflected the impact of liberalisation of the economy since the early 1990s as well as gradual opening up of the capital account. As part of the capital account liberalisation, FDI was gradually allowed in almost all sectors, except a few on grounds of strategic importance, subject to compliance of sector specific rules and regulations. The large and stable FDI flows also increasingly financed the current account deficit over the period. During the recent global crisis, when there was a significant deceleration in global FDI flows during 2009-10, the decline in FDI flows to India was relatively moderate reflecting robust equity flows on the back of strong rebound in domestic growth ahead of global recovery and steady reinvested earnings (with a share of almost 25 per cent) reflecting better profitability of foreign companies in India.



Here we can see that FDI in India has shown a gradual increase since the year 2000 and it peaked in 2011-12. As stock valuations dipped, overseas investors were eager to pick up stakes in Indian companies. London-listed Vedanta acquired a controlling stake in Cairn India for $9 billion. British major BP paid $7.2 billion for a stake in oil and gas fields operated by Reliance Industries and Vodafone Group purchased partner Essar's shares in their telecom joint venture. In terms of sectors, drugs and pharmaceuticals saw the maximum jump, with an over 15-fold increase. In contrast, the automobile and housing and real estate sectors saw FDI decline. Investment in the petroleum sector jumped significantly too.

8. RECENT DEVELOPMENTS IN FDI IN THE LAST 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 Eti had picked up a 24 per cent stake in Jet Airways that was worth over Rs 2,000 crore (US$ 319.39 million).

New Zealand is looking to establish an office in Mumbai to broaden its education footprint in India. It plans to set up an education promotion and market development role within the New Zealand Consulate General, Mumbai. There was an increase of more than 10 per cent in student visas issued to Indian nationals in 2013, making India among the fastest growing student markets for New Zealand.

Korean South-East Power Company (KOSEP), part of South Korean state-owned power generator Korea Electric Power Corporation, has signed an initial agreement with Jinbhuvish Group, Mumbai, for technical support for its Rs 3,450-crore (US$ 549.31 million) project in Maharashtra. The 600 megawatt (mw) power plant, which will be set up in Yavatmal district, is expected to be commissioned in 2016.

India and UAE have agreed to promote collaboration in renewable energy, focusing in the areas of wind power and solar energy. A Memorandum of Understanding (MoU) was signed by Dr Farooq Abdullah, Minister of New and Renewable Energy of India and Dr Sultan Ahmed Al Jaber, Minister of State of UAE in Abu Dhabi on January 18, 2014.

Luxury watch brand Jaeger-LeCoultre from Switzerland has filed for a 100 per cent single brand application to enter the Indian retail market. It thus became the first luxury company to apply for FDI through this route. Geneva-based Richemont SA that owns the luxury brand filed the application with the Department of Industrial Policy and Promotion (DIPP).

France's Lactalis, the biggest dairy products group in the world, will most likely buy out Hyderabad-based Tirumala Milk Products for US $275–300 million, according to sources. Lactalis has a yearly turnover of about US $21 billion. Tirumala had a turnover of Rs 1,424 crore (US$ 226.71 million) for FY 2012–13. The Hyderabad-based company, which was founded in 1998, makes dairy products such as sweets, flavoured milk, curd, ice-cream, etc.

9. POLICY INITIATIVES

The Ministry of Home Affairs has finally given the approval to the proposal of allowing FDI in railways. The Cabinet Committee on Economic Affairs (CCEA) is expected to consider the proposal. Foreign investors can invest only in construction and maintenance of railway projects, and not in operations. India's Prime Minister Mr. Manmohan Singh has sought increased Japanese investment in the country at the annual summit level meeting between Japan and India. The two countries are already looking at the possibility of concrete cooperation in areas such as manufacturing and research and development in the electronic industry and energy efficient and energy saving technologies. The presence of Japanese companies in India increased by 16 per cent in 2013.

The Andhra Pradesh State Investment Promotion Board has given the approval to six major investment proposals that will have a total investment of Rs 6,500 crore (US$ 1.03 billion). The proposals include those by multinational companies such as PepsiCo, Cadbury, Colgate, Johnson & Johnson, Gerdau Steels and ITC. PepsiCo's unit will be the largest beverages plant in India with an investment of Rs 1,200 crore (US$ 191.06 million). Similarly, Cadbury is establishing its facility in Sri City with an investment of Rs 2,500 crore (US$ 398.07 million).

In an effort to improve capital flows into the country, the Indian government has allowed 100 per cent FDI under automatic route in storage and warehousing, which includes warehousing of agriculture products with refrigeration. The

government has also set up National Centre for Cold Chain Development (NCCD) which will look at standards and protocols for cold chain infrastructure.

Based on the recommendations of Foreign Investment Promotion Board (FIPB) made on December 30, 2013, the Indian government has agreed to five FDI proposals amounting to Rs 1133.41 crore (US$ 180.16 million) approximately. On November 13, 2013, it had approved 12 proposals of FDI amounting to Rs 821.63 crore (US$ 130.73 million) approximately. The FIPB has also approved Swedish clothing major Hennes & Mauritz (H&M) AB's proposal to open 50 stores across India. The investment will be around Rs 720 crore (US$ 114.61 million).

10. FUTURE OUTLOOK

India is estimated to require around US$ 1 trillion during the 12th Five-Year Plan period (2012–17), to fund infrastructure in sectors such as roads, airports and ports. The government is in the process of liberalising FDI norms in construction activities and railways, which could bring in investments to meet the target. The government is also relaxing FDI norms in other sectors for foreign investors to invest. FDI in multi-brand retail has been allowed up to 51 per cent. The minimum requirement for the FDI is US$ 100 million, of which at least 50 per cent must be invested in 'backend infrastructure' within three years following the induction of the FDI. FDI limit in single-brand retail has been increased to 100 per cent; 49 per cent will be under the automatic route and the rest through the FIPB route.

11. CONCLUSION

India's Foreign Direct Investment (FDI) policy has been gradually liberalised to make the market more investor friendly. The results have been encouraging and FDI in India has increased substantially. 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 an economy like India which has tremendous potential, FDI has had a positive impact. FDI inflows supplement 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. FDI works as a booster in enhancing overall development of the economy which leads to the high economic growth rate.

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