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Impact of Foreign Direct Investment on Indian Service Sector

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Abstract

The service sector with a share of 55.2 percent in India's gross value added continued to be the key driver of India's economic growth. The service sector is not only the dominant sector in Indian economy but has also attracted significant foreign investment inflow, contributed significantly to export as well as provided large scale employment .India's service sector covers a wide variety of activities such as trade, hotel and restaurants, transport, storage, communication, financing, insurance, real estate, business service, community, social and personal services, and services associated with construction. In the last decade, the pace of economic growth and progressive policy liberalization has made Indian attractive destination for investment from all over world. India's FDI policy has become more and more liberal in last few years. The opening up of service sector which is most preferred sector for FDI will definitely help India to realize its potential of economic growth in the world level.

Keywords: FDI, Insurance Sector, Financial Inclusion, Capital Market, Funding.

Introduction

Foreign capital plays a constructive role in a countries economic development. Sometimesdomestically available capital is inadequate for the purpose of various development activities. Foreign capital is an important instruments of fulfilling the gap between the domestically available supplies of saving, government revenue, foreign exchange and the planned investment necessary to achieve development target. This is so much important in the cause of developing economy like India.

The service sector is the important segment of Indian economy. This sector in India comprises a wide range of economic activities including social and personal services, transportation, communication, financial, real estate and business services and trading. The sector which accounts for around 60 percent of the countries Gross DomesticProduct(GDP), has emerged as one of the largest and fastest growing sectors not just in the countries but in the global level. Service sector provide substantial output and employment in the global landscape. For most economy around the world, service sector is the largest part of their economy. The service sector in India received foreign direct investment of $435764 million during the period April 2000-june2019, data released by department of industrial policy and promotion. Service sector is largest sector of Indian economy, it provide highest value added and substantial employment generation. Service sector accounts for 54.40% of India's GVA in 2018-19, with an increase of 6%over 2000-01.

Post Reform Era

In 1991, privatization, globalization and liberalization (LPG) aimed that making the Indian economy a world level competitive and faster growing economy. Foreign capital is seen as an instrument by which we can achieve an additional domestic saving resources and additional productive assets in the economy. The series of reforms undertaken with respect to banking & insurance,financial sector,trading,telecommunication, real estate,construction, tourism,hotel&restaurants,housing and township business. Such service sector has almost hundred percent investment with different routes and witnessed a major boom and contributes to both employment and national income in the growth of Indian economy after reform.

Review of Literature

The role of foreign capital and service sector development on economic growth has been widely discussed in the literature. De Mello (1997) argued that FDI enhance long run economic growth via technological progress, capital accumulation and human capital creation.

The role of financial sector development on economic growth was first studied by Schumpeter (1911) later studied by Patrick (1966) represent that financial sector increase economic growth via the following channels: reallocation of resources from traditional to growth enhancing sector and promotion of entrepreneurship in growth inducing sector. King and Levine (1993) also argued that service sector development enhance the return on innovation by providing three services. These services include the following: effective evaluation of investment projects through the acquisition of information; ability to pool and mobilize household saving for innovative endeavors, and ability to share and diversify risk to enhance innovation of intermediate good.

The most recent studies have used the endogenous growth theory to capture the complementary impact of FDI and financial sector development on economic growth. In Hermes & Lensink (2003), the cost of innovation was specified as function of FDI, where the cost falls as FDI inflow increases. The study showed that the financial sector development increasethe speed of innovation and technological spillovers from FDI. Using the ordinary least square method, the study showed that FDI will only have a positive impact on economic growth if the domestic financial sector is well developed. Similar result was finds out by Alfaro (2004), using banking sector parameter and stock market indicators. In some cases, FDI becomes attracted by specific sectors that is natural resources industries, tourism, service & manufacturing sector in foreign countries.

Development of service sector is considered as important determinants of FDI inflows to Brazil, Russia, India and china (BRIC) nations (Kaur, Yadav, & Gautam 2013). Karras (2006) found that the effect of foreign aid on economic growth is positive, permanent and statistically significant. Kamath (2008) suggested that FDI has a significant positive impact on export and economic growth in India. Adding to this foreign aid contributes to factor economic development, increased employment, income and ultimately it will help to reduce the poverty level in the recipient countries.

In last 10 years, two major economic problem faced by India. first is sudden fall in growth rate of economy due to global financial crises of mid 2007 and second is ongoing depreciation of Indian currency catch the attention of many academician and researchers. It pit a big question on the importance of foreign capital inflow and its impact on economy. Some researcher and academician argue that free inflow and outflow of foreign capital are one of the major causes of currency depreciation. So it is better for Indian economy to generate more amount of domestic capital rather than foreign capital. Many policy maker’s and academician became skeptical not only about the benefits of free flow of capital, but also see uncontrolled capital flows as risky and destabilizing. Krugman (1998) underlined the the problem of moral hazard in financial intermediaries and noted that it can lead to overinvestment at the aggregate level, overpricing of assets and vulnerability of such a regime to financial crises.

Nevertheless, the debate about the benefits and cost of foreign capital flows continued in the literature. Many economist continued to firmly believe that free capital flow will create a more efficient allocation of resource and greater economic growth. Empirical studies found no evidence of an increase in inflation as an appreciation of exchange rate. Their results also suggest that stock returns represent a lower cost of capital after reform era. They found no evidence of enhance in stock market , inflation and exchange rate volatility after reform period .Found results indicating that well developed financial market allow significant gain from FDI, and a strong service sector enhance productivity of foreign direct investment.

While the debate on the effect ofFDI on service sector and specially banking sector is still ongoing. In India service sector growing rapidly. Highest proportion of foreign capital comes in the service sector. Although various research works have been done on this particular but still there is scope of further studies since effect of FDI on service sector is ambiguous in nature and therefore this research gap must be filled.

Objective of Study and Hypothesis

By considering both success and failure of foreign capital inflow,it is important to examine whether FDI has any significant impact on service sector or not. The study aim to examine the long run impact of foreign capital on service sector. The other objective are:

1. To analyze the impact of FDI on banking sector.
2. To analyze the impact of FDI on capital market.
3. To analyze the impact of FDI on non banking financial capital

For that we set up a statistical hypothesis as-

H0 : There is no significant relationship between FDI and service sector.

H1 :There is significant relationship between capital inflow and service sector.

FDI and banking sector

Banking sector is one of the most important segment and highly dominant sector in Indian economy. Banking industry in India represent remarkable progress since few years. In spite of financial and economic slowdown banking sector provide high employment and financial inclusion. After globalization, many Indian banks are emerging at global level and providing global competition in terms of innovative product and sound financial status. The financial sector always play a key role for overall development of any economy and the banking sector is the most important sector amongst all. Emergency of internet banking, plastic card, debit card, credit card, and mobile banking provide competitive atmosphere and attract the customers. This study aim to examine the effect of foreign direct investment on banking sector. Foreign direct investment has positive effect on total business, business per employee (BPE), and total revenue of banking sector. Today, Indian banks are technology neutral as their counterparts in developed economy. After reform period specially in the era of globalization, Indian banks going global and many global bank setting their business in trade. Foreign direct investment provide more enhancing efficiency of the Indian banking sector, creating innovating financial product and enhancing capitalization of banks. Foreign direct investment enhancing competition and providing high level technology, better risk management, financial stability, innovative financial product and employment in banking sector.

1. FDI providing benefit to banking sector
2. Transfer of efficient technology in domestic market from overseas countries.
3. FDI provide employment risk management system in banking sector.
4. FDI provide better capitalization.

FDI and Non-Banking Financial Companies (NBFCs)

After the reform period, foreign investors shows significant interest in Indian non banking financial companies. An NBFC is a company registered under Indian company law and engaged in the business of loan and advances, acquisition of share, bond securities issued by government or Local authority. NBFCs are governed by RBI. Foreign direct investment allowed in following activities:

1. Merchant banking
2. Portfolio management services
3. Investment advisory services
4. Financial consultancy
5. Stock broking
6. Asset management
7. Credit rating agency
8. Micro credit and rural credit area

Foreign direct investment in such NBFCs is allowed through the automatic route. It mean there is no requirement of government or RBI approval before making investment. The foreign direct investment policy 2017 allows 100% FDI under automatic route in financial services.

Advantages of FDI in NBFCs

1. Enhancing technological advancement in FDI not only foreign capital received by home economy, techniques, research and development activities also come from abroad .
2. Creating a healthy and competitive market environment.
3. Better infrastructural facilities are possible foreign direct investment.
4. Creating higher employment opportunities.

FDI and Capital Market

To study the effect of FDI on Bombay Stock Exchange (BSE SENSEX) during the period of study, FDI is represented as independent variable and SENSEX considered as dependent variable.

Y=a+bZ

SENSEX=a+ bFDI

Where, a=intercept,b=slope

Z=Independentvariable

Y=Dependent variable

The inflow of FDI has represent incresing trend during period of 2001 to 2018.There has been direct linear relation between foreign direct investment and BSE SENSEX. It concludes that there has been significant impact of foreign direct investment on stock market.

Conclusion

The finding of the study represent that there is moderate degree of positive correlation of FDI on service sector of Indian economy. Study show direct linear relationship between BSE Sensex and FDI. Actually, after globalization inflow of FDI, accelerate service sector and its component.

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