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FDI: Historical Background & Problems associated with FDI in India

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Abstract

This research paper studies the historical background of FDI in India along with the problems associated with it. It studies the reasons behind the backwardness of our economy in attracting FDI. Some future suggestions have been also mentioned in this research paper so that the Indian economy can prosper more and more in future and can be transformed into a developed economy very soon.

Keywords: Portfolio Investment, Balance of Payment, Business Enterprise, Globalisation, Internationalization.

Introduction

Foreign Direct Investment (FDI) can be understood simply as some kind of investment put in by Multi National Companies (MNCs) or Multi National Enterprises (MNEs), or by some Non-resident in some kind of company in another country (host /recipient), over which they (investor) have some control, and in lieu, earn private return. A foreign direct investment (FDI) is a controlling ownership in a business enterprise in one country by an entity based in another country. (FT Lexicon).

Foreign direct investment is distinguished from portfolio foreign investment, a passive investment in the securities of another country such as public stocks and bonds, by the element of "control" (FT Lexicon). According to the *Financial Times*, "Standard definitions of control use the internationally agreed 10 percent threshold of voting shares, but this is a grey area as often a smaller block of shares will give control in widely held companies. Moreover, control of technology, management, even crucial inputs can confer de facto control.

However, there Direct and Indirect Foreign Investment are different terms. (Annexure A). Indirect investment is all about portfolio investment, acquisition of stock of an enterprise, medium-term and long-term loans by financial institutions and intermediaries, and investment in new issues of national loans, bonds and debentures. The direct investment is a long-term equity investment in a foreign company that gives the investor managerial control over the company (Griffiths and Hall 1984).

Similarly, FDI is taken as an equity capital in India, though the IMF guideline also stipulates to include reinvestments and venture capital on the FDI flows (RBI 2003). Accordingly, the Government of India redefined the FDI inflows in 2002 and included reinvestments and venture capital along with equity capital.

According to Grazialetto-Gillies (2012), prior to Stephen Hymer's theory regarding direct investment in the 1960s, the reasons behind Foreign Direct Investment and Multinational Corporations were explained by neoclassical economics based on macro-economic principles. These theories were based on the classical theory of trade in which the motive behind trade was a result of the difference in the costs of production of goods between two countries, focusing on the low cost of production as a motive for a firm's foreign activity.

For example, Joe S. Bain only explained the internationalization challenge through three main principles, which are: Absolut cost advantages, product differentiation advantages and economies of scale. Furthermore, the neo-classical theories where created under the assumption of the existence of a perfect competition. Intrigued by the motivations behind large foreign investments made by corporation from the United States of America, Hymer developed a framework that explained beyond the existing theories, why this phenomenon occurred, since he considered that the previously mentioned theories could not explain foreign investment and it motivations.

Facing the challenges of his predecessors, Hymer focused his theory on filling the gaps regarding international investment. The theory proposed by the author approaches international investment from a different and more firm specific point of view. As opposed to traditional macroeconomic-based theories of investment, Hymer states that there is a difference between mere capital investment, else known as portfolio investment, and direct investment. The difference between these two, which became the corner stone of his whole theoretical framework, is the issue of control, meaning that with direct investment firms are able to obtain a greater level of control than with portfolio investment.

Furthermore, Hymer proceeds to criticize the neoclassical theories, stating that the theory of capital movements cannot explain international production. Moreover, he clarifies that FDI is not necessarily a movement of funds from a home country to a host country, nor and that it is concentrated on particular industries within many countries and not vice versa (as would be the case if interest rates were the main motive for international investment).

Another interesting observation made by Hymer in his theory, was that opposite of what was sustained by the neoclassical theories, foreign direct investment is not limited to investment of excess profits abroad. In fact, foreign direct investment can be financed through loans obtained in the host country, payments in exchange for equity (patents, technology, machinery etc.), among others.

The previous criticisms lead Hymer to propose the three main determinants of foreign direct investment, taking into account imperfections in the market as a key assumption: Existence of firm specific advantages, their link to market imperfections, Removal of conflicts with rivals in foreign markets and propensity to formulate an internationalization strategy to mitigate risk (Ietto-Gillies, 2012).

Background

The world has turned into a global market and there has been a spectacular boom in the FDI in the global economic landscape. This once unthinkable growth of globalFDI in the 1990s all across the globe today makes FDI a very crucial and pivotal component of the overall growth and development strategy for both developed and third-world nations.

Keeping the vital aspect of FDI in mind, plans, strategies and policies are designed so as to boost and strengthen inward flows. In fact, in won't be an overstatement that FDI-if planned and implemented well-can result in a win – win situation for the two parties involved; the host nation and the home country. Both the inviter and the invitee are bound to be interested in FDI, because there are huge benefits to be reaped from such an understanding.

For the home country, there is this huge advantage that the vast markets of the host countries offer. Similarly, the host nation can benefit from the technological and managerial skills and strengthen their domestic savings and foreign exchange. In addition, the scarcity of all types of resources i.e. capital, financial, technological know- how, entrepreneurship, access to foreign markets, skills, practices, etc.

It is even more critical for the third-world or developing nations as they find FDI as a solution for all their woes and scarcities. Besides, the coming together of global financial markets has opened up a new avenue to catalyze the growth of FDI across the world. In the early 1980s, the developing countries had drastically eased restrictions on operations of MNEs and FDI inflows. This trend gained even more popularity during the 1990s, which saw a major FDI inflow into the developing countries.

In fact, developing countries received about 40 % global FDI inflows in 1994-96, as compared to 25 % in 1980-84 (United Nations Conference on Trade and Development, UNCTAD 1994). This drift in growing share of developing countries kept on going up till 1999-00, but then went down to 30 % during 2001-02. In India, Foreign investment came into being in the year 1991 under the Foreign Exchange Management Act (FEMA), which was mainly backed by then Finance Minister, Dr. Manmohan Singh. However, once he became the Prime Minister in 2004, it proved to be a major problem. India put restrictions on Overseas Corporate Bodies (OCB) to invest in India. India imposes cap on equity holding by foreign investors in various sectors. Current FDI in insurance and aviation sectors is capped at 49%.

Starting from about $1 billion in 1990, a 2012 UNCTAD survey projected India as the second most important FDI destination (after China) for transnational corporations during 2010–2012. Post year 2000, %-growth over previous year in FDI is always positive except the years 2002-03, 2003-04, 2009-10, 2010-11, 2012-13(Table 1.1).

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Table 1.1: Financial Year-wise FDI inflows Data (All figures in USD million)

S. No.	Financial Year (April-March)	FOREIGN DIRECT INVESTMENT (FDI): Equity: FIPB Route/ RBI's Automatic Route/ Acquisition Route	Equity: Equity capital of unincorporated bodies #	Re-invested earnings +	Other capital +	FDI FLOWS INTO INDIA: Total FDI Flows	FDI FLOWS INTO INDIA: %age growth over previous year (in US$ terms)	Investment by FII's Foreign Institutional Investors Fund (net)
FINANCIAL YEARS 2000-01 TO 2017-18								
1.	2000-01	2,339	61	1,350	279	4,029	-	1,847
2.	2001-02	3,904	191	1,645	390	6,130	(+) 52 %	1,505
3.	2002-03	2,574	190	1,833	438	5,035	(-) 18 %	377
4.	2003-04	2,197	32	1,460	633	4,322	(-) 14 %	10,918
5.	2004-05	3,250	528	1,904	369	6,051	(+) 40 %	8,686
6.	2005-06	5,540	435	2,760	226	8,961	(+) 48 %	9,926
7.	2006-07	15,585	896	5,828	517	22,826	(+)155 %	3,225
8.	2007-08	24,573	2,291	7,679	300	34,843	(+) 53 %	20,328
9.	2008-09	31,364	702	9,030	777	41,873	(+) 20 %	(-) 15,017
10.	2009-10	25,606	1,540	8,668	1,931	37,745	(-) 10 %	29,048
11.	2010-11	21,376	874	11,939	658	34,847	(-) 08 %	29,422
12.	2011-12	34,833	1,022	8,206	2,495	46,556	(+) 34 %	16,812
13.	2012-13	21,825	1,059	9,880	1,534	34,298	(-) 26%	27,582
14	2013-14	24,299	975	8,978	1,794	36,046	(+) 5%	5,009
15.	2014-15 (P)	30,933	978	9,988	3,249	45,148	(+) 25%	40,923
16.	2015-16 (P)	40,001	1,111	10,413	4,034	55,559	(+) 23%	(-) 4,016
17.	2016-17 (P)	43,478	1,227	12,176	3,201	60,082	(+) 8%	7,735
18	2017-18 (P) (upto September – 17)	25,354	542	5,792	2,060	33,749	-	14,359
CUMULATIVE TOTAL (from April, 2000 to September , 2017)		359,031	14,654	119,529	24,885	518,100	-	208,669

Source: (i) RBI's Bulletin November, 2017 dt.08.11.2017 (Table No. 34 – FOREIGN INVESTMENT INFLOWS).
(ii) Inflows under the acquisition of shares in March, 2011, August, 2011 & October, 2011, include net FDI on account of transfer of participating interest from Reliance Industries Ltd. to BP Exploration (Alpha).
(iii) RBI had included Swap of Shares of US$ 3.1 billion under equity components during December 2006.
(iv) Monthly data on components of FDI as per expended coverage are not available. These data, therefore, are not comparable with FDI data for previous years.
(v) Figures updated by RBI up to September , 2017.
(vi) Data in respect of 'Re-invested earnings' & 'Other capital' are estimated as average of previous two years.
'#' Figures for equity capital of unincorporated bodies are estimates. (P) All figures are provisional

When a country's markets are not developed well, they are unable to cater to the capital requirements for gigantic investment projects. Additionally, it is also extremely difficult to arrange locally the hard currency, which is required for buying investment goods. This is where FDI provides immediate solution because of the simple fact that it is a direct source of external capital.

FDI also acts to bridge the gap between the desired level of foreign exchange needed and those obtained from net export earnings (Fry 1993). This is possible because of the fact that the FDI helps bring in foreign denomination currency, thereby, helping increase the domestic country's forex reserve. FDI is also credited with creating employment in plethora of sectors in developing countries, especially, India (Lahiri and Ono 1998).

In case, the host country applies some kind of domestic content requirement on the foreign limits, the foreign firms are required to employ the underemployed and unemployed people of the domestic country. Overseas firms bring with them better technology and knowhow, thereby, reducing the set up cost in host countries. This results in low prices and improved quality goods to consumers in these countries (Sahoo et al., 2001).

Problems associated with FDI in India

Indian economy was very profoundly dependent external debt in the financial year 1990-91. This was mainly because of severe Balance of Payment (BoP) crisis, which resulted in international credit rating agencies lowering India's rating for both short and long-term borrowing. This led to borrowing in international commercial markets extremely difficult and also resulted in an outflow of foreign currency deposits of NRIs that were kept in the country.

The situation deteriorated during the Gulf war, whose major outcome was the huge rise in petroleum prices. It also caused a halt in remittances from Indian workers employed in the Gulf region. These changes meant that India was almost on the verge of default in external payments liability.

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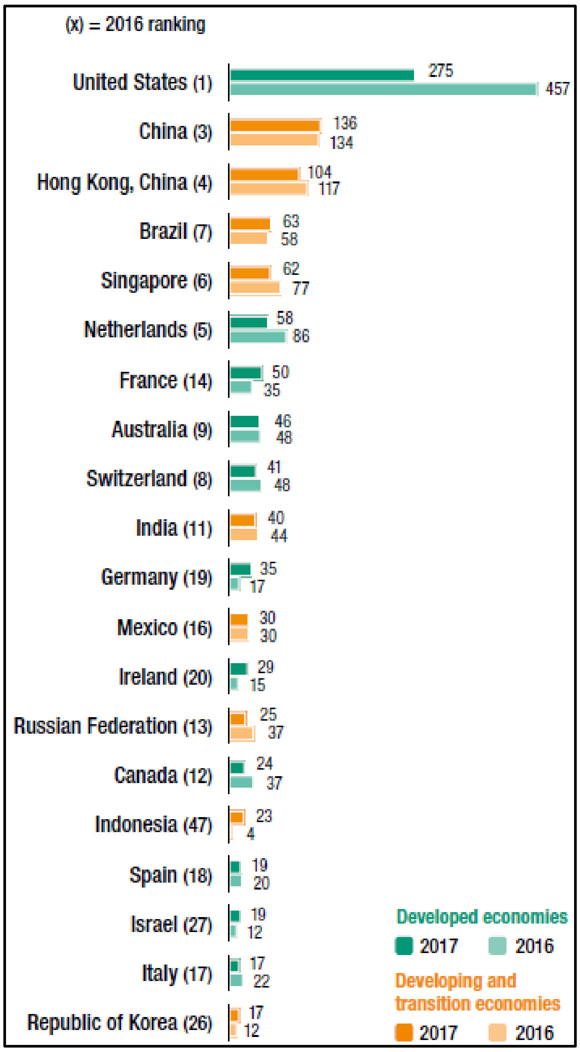
During this crisis, the Finance Minister, Dr. Manmohan Singh, brought in some revolutionary steps in the Indian economy, kick-starting a macro-economic stabilization and structural adjustment programme, which was well supported by the World Bank and IMF. India started taking giant strides with the world economy, riding the wave of globalisation. The reformatory movement led to a significant rise in the FDIflows into India during 1990s. The compound growth rate of FDI, which during 1955-1966, was 4 just per cent, went up to 75 per cent during 1991-98.

Figure 1.1: FDI inflows: top 20 host economies, 2016 and 2017 (Billions of Dollars)



Still, with all the buzz around, the FDI inflows for India are low, compared to other developing countries like Brazil, Mexico, Korea, China and Thailand. In 2017, India's FDI inflow was around USD 40 billion, as compared to China's USD 134 billion, Hong Kong's USD 117 billion, and Brazil's USD 58 billion. Interestingly there was a fall of USD 4 billion from the previous year (USD 44 billion in 2016) (Figure 1.1).

Conclusion

In October 2017 to December 2017, foreign investors had poured in $14547million in the Indian capital markets.Total equity inflows from April 2017 to December 2017 was 35941 million, a0.27% increase from 35844 million for the same period 0f the year 2016.

Future Scope of Study

It is important to analyze the factors that are hindering high FDI inflows into India, while at the same time, studying the impact it is having on the economy. The determinants of FDI inflows need to be studied at both macro and sector levels.

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