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Impact of Foreign Investment on the Indian Economy: An Analytical Study

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Abstract—*With the independence of India in 1947, along with the various political and social problems, the nascent Indian government was also faced with the herculean task of stabilising the dismal economic scenario of the country. Over the years, India managed to be recognised as a strong developing country with immense potential for growth, however, like other developing countries, India also suffered from the scarcity of financial resources and low level of capital formation, which acted as a huge hurdle to the development programmes which were indispensable for the growing population. The historic economic reforms and liberalisation policy of 1991 finally paved the way for foreign investment in India. With myriads of apparent benefits of foreign investment like aiding in the creation of additional economic activity, generating employment opportunities, facilitating technology transfer, among others, India is slowly consolidating its position globally as a favourable destination for foreign investment and inviting more investment. Hence, there is a surge in the debate over the role of Foreign direct Investment (FDI) and Foreign Institutional Investment (FII) in the economic development of India. And with the recent uproar over FDI in retail, questions are being raised whether foreign investment has at all helped in boosting the Indian economy like that of China or has India just fallen prey to the interests and greed of foreign investors and would end up losing miserably in the long run. This paper seeks to analyse the role and impact of FDI and FII on the Indian economy, with a highlight on the merits and de-merits of foreign investment and the challenges India faces as an attractive investment destination.*

1. INTRODUCTION

FDI and FII form an important segment of the foreign investment received by India. Hence, these are extremely popular topics of discussions among the economists and development planners. However, there was huge ambiguity over the definition of FDI and FII. So the government constituted the Mayaram Committee [1] to state the definitions of FDI and FII in clear and explicit terms. According to the new definition, FDI is an investment where the investor has more than 10% stake in the company. On the other hand, when an investor has less than 10% stake, it is termed as FII. FDI is mainly divided into three categories- equity, loans and guarantee issued. Most investments are in the form of guarantee issued which is followed by equity and then loans. FII investment is also made mainly through two routes which include the equity investment and 100% debt route. In equity investment route, investments are generally made in securities, schemes of Unit Trust of India and warrants. While in the 100% debt route investments are made in debentures, treasury bills, bonds, dated government securities and other debt instruments.

2. LITERATURE REVIEW

Mamta[2] in her paper has discussed about the impacts of FDI and FII on the Indian economy. She has taken the FDI and FII inflows for the period 2001-2010 and showed their correlation on GDP. Sharma [3] in his paper has showed the importance of FIIs on industrial sector, Indian stock indices and Indian Capital arcade growth. Malhotra[4] and Vishwarkarma[9] in their paper have discussed the trends and pattern of flow of FDI in India and its impact on the GDP. Gulshan[5] in his paper has also discussed about the pre and post reform period of 1991 and has shown the effects of liberalization on FDI inflows in India. Nagraj[6] has discussed about the trends of FDI inflow in India and has raised some doubts on the effectiveness of FDI on the development of an economy. Banerji [7] in his paper has discussed about the merits and demerits of foreign inflows on the Indian economy. Syed[8] in his paper has used the regression model to show the impact of FDI and FII on the stock market.

3. OBJECTIVES OF STUDY

1) To study the trends of FDI and FII flow in India
2) To study the merits and demerits of FDI on economy.

4. FDI AND FII FLOW IN INDIA

FDI entry in India began as early as 1600, with the entry of East India Company in India and it continued to grow under the British in the colonial era. Later, Japanese companies also entered in India after the Second World War, however, U.K remained India's largest investor. Even after the Independence,

FDI inflows remained relatively slow till 1991 with less than $1 billion invested as FDI in India .It was only after the 1991 policy changes that the Indian economy managed to attract foreign inflows. FERA or the Foreign Exchange Regulation Act was also replaced with FEMA (Foreign Exchange Management Act, 1999) with an objective to properly develop and maintain foreign exchange market of India. It can be seen from the following graph (Fig1 & Fig. 2) that FDI inflows in India have steadily increased over the years. In spite of several global economic crises in the European Union and the US, India has formidably come up as a strong alternative for foreign investors.

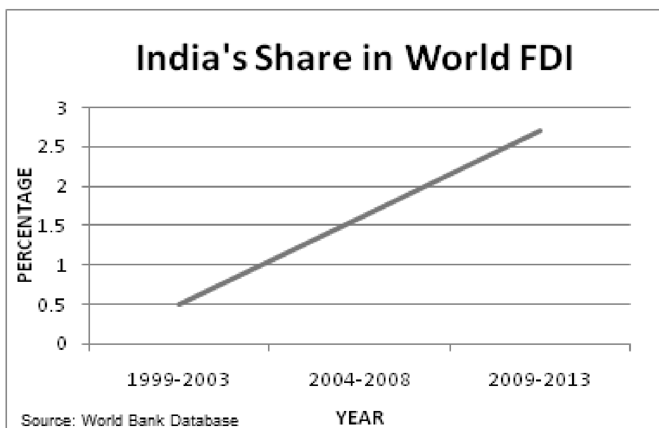

Fig. 1: India's Share in World FDI

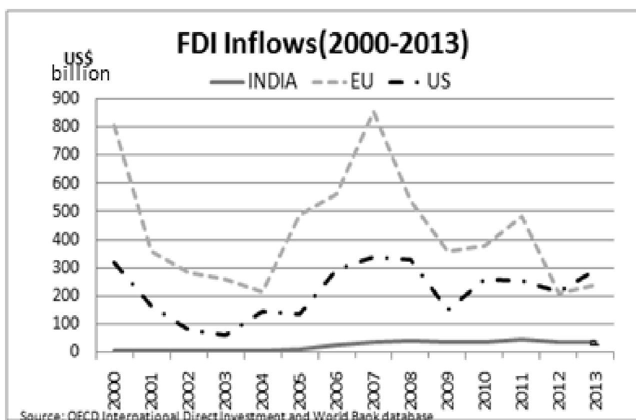

Fig. 2: FDI Inflows as compared to the world

India currently allows 100% FDI in agriculture, exploration of mines and crude oil, industrial parks, wholesale trading under the automatic route, while government approval is required for100 % FDI in telecom and single brand retail. After the recommendations of the Mayaram committee, government also relaxed FDI investment caps in 12 sectors. Further, the SEZ (Special Economic Zone) policy has also helped in increasing trade, foreign investment, job creation and effective administration. All these changes have helped India in projecting itself as a strong FDI destination for multinational corporations. DIPP (Department of Industrial Policy and Promotion) data shows the cumulative FDI inflows (including equity, reinvested earning and other capital) for the period of April 2000-March 2014 to be US$ 323 billion. During the financial year 2012-2013, two sectors defied the FDI investment trend and showed strong growth in the investment inflows- the hotel and tourism industry, which attracted US $ 3.3 billion, registering a growth of 228 percent and inflows into the automobile sector grew up by 66.5%. However, according to the DIPP fact sheet for FDI Inflows, service sector remains the largest contributor of FDI inflows since 2000 with 18% share. Following figure 3 shows a sector wise distribution of FDI inflows in India

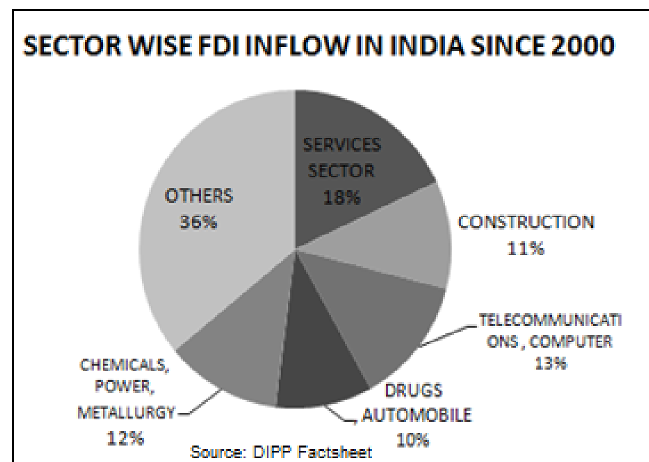

Fig. 3: Sector Wise FDI Inflow in India

India's FII inflow has also increased over the years and stood at $149 billion for the period April 2000-March 2014. However FDI when compared to FII forms the major part of foreign inflows which contributed $323 billion during the same period. According to country-wise FDI inflows into India, the contribution of Mauritius has been the highest with US$ 78 billion accounting for 36% of total investments[10]. Singapore has the 2nd highest investment figure accounting for US$ 25 billion, with a contribution of 11 %. United Kingdom, Japan and USA are the other top contributors for FDI in India. Together these top five countries contribute around 70% of the total FDI inflow in India while the top 10 countries contribute almost 90% of the total FDI inflow in India. The other five countries include Netherland, Cyprus, Germany, France and Switzerland.

5. FDI, FII AND GROWTH RATE

Correlation factor is used to determine the relationship between FDI, FII and GDP growth rate (%). The data for FDI and FII were collected from DIPP databases for a period of 14 years. Correlation factor is a mathematical tool which is used to determine the extent to which two variables movements are

correlated. Correlation values vary from -1 to 1, a value of -1 or negative correlation signifies that if value of one variable increases then the value of other variable will decrease and if the values is +1 or there is positive correlation then the value of both variables increases simultaneously. Following is the table (Table 1) for FDI, FII and growth rate for India during the period 2000-01 to 2013-14.

Table 1: For FDI and FII inflow during 2000-01 to 2013-14

Financial Year	FDI(in U.S.$million)	FII(in U.S.$million	GDP Growth Rate(%)
2000-01	4029	1,847	4.15
2001-02	6130	1,505	5.39
2002-03	5035	377	3.88
2003-04	4322	10,918	7.97
2004-05	6051	8,686	7.05
2005-06	8961	9,926	9.48
2006-07	22826	3,225	9.57
2007-08	34835	20,328	9.32
2008-09	41,874	-15,017	6.72
2009-10	37,745	29,048	8.59
2010-11	34847	29,422	8.91
2011-12	46556	16812	6.69
2012-13	34298	27582	4.47
2013-14	36,396	5010	4.86
Source: DIPP FDI Factsheet March 2014			

After the statistical analysis it was found that FDI has a low positive correlation on the growth while FII has a moderate positive correlation on the growth. The following table shows the correlation factor for FDI and FII with growth rate.

Table 2: Correlation Factor

Correlation Factor	FDI	FII
Growth rate	.18	.37

From this table(Table 2) it's explicit that there is some correlation of FDI and FII on Growth rate, but it's a weak one**.** Therefore it can't be conclusively stated that there is a direct dependence between FDI, FII and growth rate (%).

6. MERITS

6.1. Development-Foreign inflows really help in stimulating economic development by creating both benefits for the raw material industry as well as for the investor. They also add to the growth of the country by boosting the economic activity and by sharing technology between countries.

6.2. Employment- Foreign inflows are often used for setting up new industries and this gives a number of opportunities to both the skilled as well as unskilled labour. Special Economic Zones (SEZ) are specially built for an equitable development of both the industry as well human resource.

6.3. Source for earning foreign exchange- They provide a good source for earning dollar exchange and thus help in reducing the Current Account Deficit and the Balance of Payment of the country.

6.4. Export and Import- FDI opens a wide range of opportunities for trade facilitation including both exports and imports and thus helps in improving relations between countries.

6.5. Management- Companies with foreign investment also have better corporate governance which is essential to overcome problems between management and investors.Foreign inflows also help in knowledge transfer with companies sending their employees for overseas training and projects. Consumers also benefit by having a chance to choose from a wide range of competitive products.

7. DEMERITS

7.1. Vulnerability- FDI when compared to FII is considered to be long term investment and is therefore more beneficial for a stable economy, however, a greater dependence on foreign inflows can increase India's vulnerability to a sudden reversal of investor's sentiment as witnessed in 2008 and 2013. In 2008 and 2013 a sudden drop in foreign inflows was caused mainly due to subprime loan crisis, debt tension and tightening of monetary policies and all this had led to instability in our economy.

7.2. Inflation- FII Completely opening the economy to foreign inflows can also lead to inflation as excess of foreign inflow will create a demand for rupee and RBI will have to pump that rupee in the market to meet that demand.

7.3. Uncompetitive Exports - Too much of foreign inflows can also lead to rupee appreciation and it makes the exports less competitive. Even the small investors find it tough to compete with the large investors and thereby large foreign industries get a chance to create a monopoly in the market. Therefore focus should be on removing structural vulnerabilities and strengthening the infrastructure so that even in the case of negative investor sentiment and global crises our economy is not affected.

8. CONCLUSION

When the shy and deficit burdened India opened up to foreign investment in the 1990s on the explicit poking by the IMF, many raised their eyebrows over the feasibility of foreign investment for India. Even after two decades of foreign investments, we still have discussions, debates and at times protests (against the proposal for 51% FDI for multi brand

retail) on these issues. However, undoubtedly, India has shown immense thirst for foreign investment in the recent times and it has paid off handsomely for India. India has been projected as the second most important FDI destination after China for transnational corporations during 2010-12. However, India still has to go a long way to let the foreign investment fructify substantially.

Though both FDI and FII are welcomed for economic growth, however, FDI plays a more important role than FII in the advancement of any developing country especially like India. FDI enriches the country not only with the inflow of foreign funds and investments but also results in the transfer of advanced technology and skills, thus creating job opportunities. Although both types of foreign investments provide an impetus for economic and industrial expansion, however India should focus more on attracting FDI as it stays for longer period, for its exist policy is not as easy as for FIIs, which is at times considered as hot money. Also, as opposed to FII, the FDI in manufacturing, infrastructure etc. leads to the creation of assets, which will remain within the territorial boundaries of the country even if the foreign investor wishes to withdraw from the company. However, in India it has been much easier to attract FII because of less procedural requirements as compared to FDI where the licensing requirements are too cumbersome.

Today the Indian industry is being viewed as competitive in the international market. But despite all this, deep down, the Indian economists and government know that India has still not done enough to open up its market. Stringent policies, infrastructural hiccups, bureaucratic delays, stubborn labour laws still waters down the energies and desires of foreign investors to invest in India. Also, with frequent intra-governmental opposition, India has often portrayed itself as a banana republic in the eyes of the eager investors. Even today the foreign investment policy lacks a clear focus. Though now the government seems to be rushing ahead with quick and often ad-hoc policies, the real focus should not only be to grab maximum investment, but investment in the right and appropriate sectors. We should not merely ape other countries, but try to plan our foreign investment policies to tap the foreign investment in a manner which augments our strengths which are the availability of skilled workforce, cheap labour, and the size of the domestic market. In short, now, we just don't need to work hard to attract foreign investment, but also need to work smart to gain the maximum out of it.

9. ACKNOWLEDGEMENT

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