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Post-reform Impact of FDI on Economic Growth in India

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Abstract

Foreign direct investment (FDI) is a strategic movement of resources arising out of a country's economic reforms. In the wider context of globalization, post-reform policies influence the introduction and involvement of foreign investment in various sectors of the economy of a developing country like India. Indian economy recorded a positive growth even during the recent global meltdown, attracted overseas investors as an attractive investment destination with prospects of high returns. India is a fascinating country from an economic standpoint because it is so diverse. The inflows of FDI in India registered 11 per cent growth during the fiscal year '09 as compared to fiscal year '08. FDI equity inflows as per centage of GDP have increased from 0.75 per cent 2005-06 to nearly 2.49 per cent in 2008-09. India's share of world FDI jumped from 0.78 per cent in 2005 to 2.45 per cent in 2008. As a result, the country's economy is growing more rapidly. From 2004 until 2010, India's average quarterly GDP growth was 8.37 per cent reaching an historical high of 10.10 per cent in September of 2006. In the direction, this paper provides a quantitative study of FDI potential and its impact on growth in Gross domestic Product in Post-reform period.

Key Words : FDI, GDP, Post-reform

INTRODUCTION

The economy of India is the eleventh largest economy in the world by nominal GDP and the fourth largest by purchasing power parity (PPP). Following

strong economic reforms from the socialist inspired economy of a post-independence Indian nation, the country began to develop a fast-paced economic growth, as free market principles were initiated in 1990 for international competition and foreign investment. India is an emerging economic power with a very large pool of human and natural resources, and a growing large pool of skilled professionals. Economists predict that by 2020, India will be among the leading economies of the world.

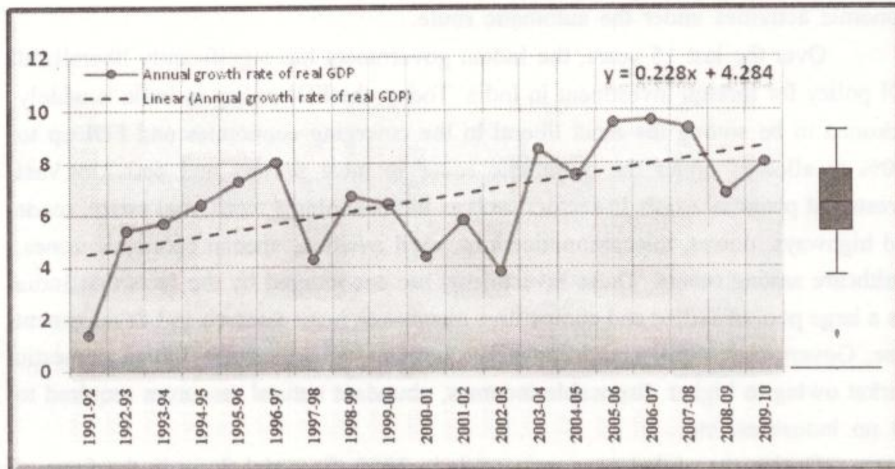
India's economic performance in the post-reforms period has many positive features. The average growth rate in the ten year period from 1992-93 to 2001-02 was around 6.0 per cent , as shown in Figure 1, which puts India among the fastest growing developing countries in the 1990s. This growth record is only slightly better than the annual average of 5.7 per cent in the 1980s, but it can be argued that the 1980s growth was unsustainable, fuelled by a build up of external debt which culminated in the crisis of 1991. In sharp contrast, growth in the 1990s was accompanied by remarkable external stability despite the East Asian crisis. Poverty also declined significantly in the post-reform period.

Since 1991, continuing economic liberalization has moved the country toward a market-based economy. A revival of economic reforms and better economic policy in 2000s accelerated India's economic growth rate. In recent years,Indian cities have continued to liberalize business regulations and recorded an average growth rate of 7.9% since 2002-03. By 2008, India had established itself as the world's second fastest growing major economy. But the year 2009 was not really good for the Indian equity market and the whole economy was also going into recession.

The year 2009 saw a significant slow down in India's GDP growth rate to 6.8% as well as the return of a large projected fiscal deficit of 6.8% of GDP which would be among the highest in the world. The global economy seems to be recovering after the recent economic shock. The Indian economy, however, was hit in the latter part of the global recession and the real economic growth witnessed a sharp fall, followed by lower exports, lower capital outflow and corporate restructuring. It is expected that the global economies will continue to sustain in the short-term, as the effect of stimulus programmes is yet to bear fruit and tax cuts are working their way through the system in 2010. Due to the strong position of liquidity in the market, large corporations now have access to capital in the corporate credit markets.

In order to sustain economic growth during the time of the worst recession, government authorities in India have announced the stimulus packages to prop up economic growth. To finance the stimulus packages, the Indian government has

Figure 1 : India's Economic Outlook Projection



Data Source : Economic Survey 2010-11

raised over $100 billion over the last four quarters in a way to finance the stimulus package. The country's public debt, according to the RBI, has surged to over 50% of the total GDP and the RBI has started printing new currency notes.

FDI Investment in India

One of the factors responsible for the tremendous growth of the Indian economy has been its booming foreign trade. The economists worldwide are predicting a resurgent India riding on the back of renewed trust on the foreign direct investments. Improving global sentiment and a growing conducive environment in India are increasingly facilitating foreign investors' role in the country currently. Several other factors being attributed to the revival in foreign direct investments (FDI) in the country include liberal investment policies and reforms, innovative and technological advanced products being manufactured in India, and low cost and effective solutions.

FDI policy is relevant to foreign entities seeking to establish an Indian presence by setting up an Indian company (either wholly owned or in a joint venture with an Indian partner) or by acquiring a stake in an existing Indian company. In recognition of the important role of Foreign Direct Investment (FDI) in the accelerated economic growth of the country, Government of India initiated a slew of economic and financial reforms in 1991. India is now ushering in the second generation reforms aimed at further and faster integration of Indian economy with the global economy.

As a result of the various policy initiatives taken, India has been rapidly changing from a restrictive regime to a liberal one, and FDI is encouraged in almost all the economic activities under the automatic route.

Over the last 15 years, the Indian government has significantly liberalized FDI policy for foreign investment in India. Today, the FDI policy in India is widely reckoned to be among the most liberal in the emerging economies and FDI up to 100% is allowed under the automatic route in most sectors and activities.Vast investment potential exists in sectors such as biotechnology, retail, real estate, roads and highways, power, telecommunications, civil aviation, special economic zones, healthcare among others. These investments are encouraged by the facts that India has a large pool of skilled and competitive manpower, huge research and development base, Government support and conducive policies, growth in the Indian domestic market owing to higher disposable incomes, abundant natural resources required to set up industries, etc.

During the global economic crisis in 2008, financial flows in the form of FDI to developing economies might be expected to slow down. But according to UNCTAD (2009), FDI inflows to developing countries remained positive for 2008 at an estimated 4% from US$499 billion in 2007 to US$ 518 in 2008. Decline in FDI inflows to the developing world were expected to be more widespread in 2009. But FDI inflows to India remained buoyant indicating favourable long-term prospects for the economy.

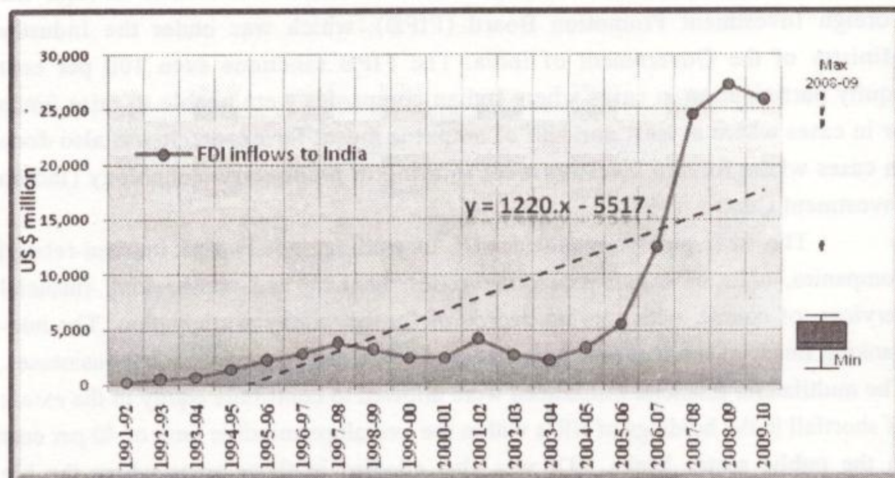
According to the World Bank, developing countries should endeavor to attract more foreign direct investment because, it encourages production improvement, contributes to the advancement in technology, boosts employment opportunities, bolsters business sector competition and creates exports. However, it has been accepted that impact of FDI on economic growth has been dual ie, both positive as well as negative effect. Previous literature suggests that the FDI inflows has negative rather than positive spillovers in transition economies (see Gorg and Greenaway, 2002). Findlay (1978) postulates that FDI increases the rate of technological progress in the host country through a "Contagion" effect from the more advanced technology, management practices, etc.

The FDI policy rationalization and liberalization measures taken by the government have resulted in increased inflows of FDI over the years. During the financial year 2010-11 (from April 2010 to June 2010), FDI worth US$ 5.81 billion was attracted in India. Cumulative amount of FDI from August 1991 to June 2010 registered in India stood at US$ 138.24 billion. During 2010-11 (April-June), services sector attracted 21 per cent of the total FDI equity inflow into India, while computer software and hardware attracted second largest amount of FDI with 9 per cent share

during the same period. Telecommunications was the third highest sector attracting FDI with 8 per cent of total inflows followed by housing and real estate, and construction activities which garnered 8 per cent and 7 per cent share respectively. Similarly, during 2010-11 (April-June), Mauritius was the top investing country for India with 42 per cent of the total inflows. Singapore was second with 10 per cent share, U.S.A. stood third with 7 per cent share. U.K. and Netherlands were on fourth and fifth places with 5 per cent and 4 per cent shares respectively.

Figure 2 depicts the historical FDI inflows in India since April, 1991. The graph indicates a boom in FDI inflows after 2006 with average US$ 225 billion during 2006-10 in comparison to US$ 25 billion during 1991-2005. Trend line developed for the data 1991- 2010 also shows a positive average change of US$ 12 billion in a year. This change can be observed to US$ 42 billions with trends since 2006.

Figure 2 : FDI Inflows in India



Data Source : Economic Survey 2010-11

Policy Measures for FDI in the Post-Liberalization Period

Broadly speaking, the new policy was initiated to increase the stake of foreign investors in Indian companies, provided a bigger room for their entry, axed the procedural formalities,provided additive incentive for the import of technology and to the NRIs. Thus, the main objective of the new FDI policy was to create a congenial environment for FDI inflows in India. Diluting the provisions of the Foreign Exchange Regulation Act (FERA), the new policy removes the 40 per cent ceiling for foreign equity participation that existed during the pre-reform period. Moreover, it provided for automatic approval of foreign collaborations in many

cases. In the case of nine categories of industries, viz. mining services, basic metal and alloys, electric generation and transmission, non-conventional energy generation and distribution, construction, land and water transport, storage and warehousing services and some manufactures like industrial and scientific instruments, the RBI granted automatic approval of foreign collaboration even if foreign participation in equity goes up to 74 per cent. In the case of infrastructural projects of this group, automatic approval would be availed even with 100 per cent foreign equity participation. In case of three categories of industries, such as mining of iron ore, metal ore and non-metallic minerals, foreign equity participation was not to exceed 50 per cent if automatic approval was expected. In addition to this, in 1999-00, the list of automatic approvals was widened covering important industrial and services sectors (Secretariat of Industrial Assistance, SIA Newsletter, 2001).

However, if a foreign investor wished to have greater participation in equity than that mentioned above, documents had to be routed through the Foreign Investment Promotion Board (FIPB), which was under the Industry Ministry of the Government of India. The FIPB sanctions even 100 per cent equity participation in cases where Indian companies were unable to raise funds or in cases where at least one-half of output is meant for export. It was also done in cases where foreign investors were to bring in proprietary technology (Indian Investment Centre, 1997).

The new policy extended FDI to trading, hotels and tourism-related companies, units of export-processing zones, banking and non-banking financial services, of course, with varying degree of foreign equity participation. The non-banking financial services now included credit card and money-changing businesses. The multilateral financial institutions were allowed to contribute equity to the extent of shortfall in the holdings of NRIs within the overall permissible limit of 40 per cent in the public sector banks. FDI was also allowed in those areas where the big industrial houses were not previously allowed to invest. The new policy permits for opening of branch/liaison offices of foreign companies, revoking the prohibition of 1973. The branch office could be set up for conducting research and development, undertake export/import activities and for making available desired technology. An offshore venture capital company might contribute to an entire equity base of a domestic venture capital fund and might also set up a domestic asset management company (Indian Investment Centre, 1997).

FDI does not always involve investment in cash. A purely technical collaboration involves permission to use patents or trademark and transfer of technology for which the Indian Company pays royalty, technical service fees. In case of technology import, the new policy also provides for automatic approval if

the collaboration agreement involves royalty payment up to $ 2 million (net of taxes) to be made in a lump-sum amount or up to 5 per cent of domestic sale and 8 per cent of export over a ten-year period from the date of agreement or seven years from the date of commencement of business. In hiring of foreign technicians, there is no bar if the RBI guidelines are followed. There is also no bar on the use of foreign brand name.

The policy cuts the procedural delays significantly. Abolition of industrial licensing almost in all cases (except public sector units and those units producing hazardous items) is another example. The Foreign Investment Promotion Council was set up in 1996 to identify projects within the country that required foreign investment and to target specific countries from where FDI could be brought in (Indian Investment Centre, 1997). To foster speedy approvals, the FIPB had been asked to give its decision within a period of 30 days, For speedy implementation of the approved investment. the government set up the Foreign Investment Implementation Authority that convened its first meeting in the last week of September 1999 (SIA Newsletter, 2000).

The NRIs making FDI got special treatment. They made direct investments either on repatriable terms or on non-repatriable terms. In case of repatriable investments, their share can go up to 100 per cent of the equity if the project concerns high-priority industry, housing and real estate development, air taxi operations, sick unit, 100 per cent export-oriented units or a unit in export-processing Lone and a trading house. On non-repatriable terms, NRIs' participation could go up to 100 per cent of bonus issues in an Indian company if the company is not engaged III agriculture or plantation and real estate. Non-repatriable investment could also flow into proprietary/partnership concerns engaged in industrial, trading and commercial activities (SIA Newsletter, 2001).

The Indian government became quite liberal regarding dividend repatriation abroad.There was no bar if taxes were paid. However, in a limited number of consumer goods, such outflow had to be balanced with export earnings for a period of seven years. Disinvestments 100 could be made subject to a few RBI formalities. Foreign Direct Investment proposals under the policy are approved under two routes, viz. automatic route and Foreign Investment Promotion Board (FIPB) route. Apart from this, the Foreign Investment Implementation Authority (FIIA), Foreign Investment Promotion Council (FIPC) and the Secretariat of Industrial Assistance (SIA) also helped to facilitate the promotion of FDI in India.

Role of FDI in Economic Growth of India

There has been a growing interest and huge competition to strengthen the

respective attracting forces of FDI as a part of globalization agenda in most of the developing countries like India. The main interest for such agenda is to use these FDI in the development process of the economy as FDI may provide intangible asserts including technology, potential spillover and externalities, which are highly beneficial for host country's economic growth. In the race for seeking more and more FDI inflows, the countries have overlooked the fact that all the FDI do not benefit their host countries similarly (Kumar, 2000). The impact of FDI on the domestic economy mainly depends on the domestic policy, the kinds of FDI the domestic country receives and the strength of domestic enterprises. The question of measuring the impact of FDI inflows in India is pertinent, as FDI has become a preferred finance for growth than the formal contractual agreements for foreign loans. FDI appears attractive to India because it involves a risk sharing relationship with the investors from the home countries. Such risk sharing does not exist in the formal contractual agreements for foreign loans. In fact, FDI appears particularly attractive, as existing stocks are low in India. Low stocks of foreign owned capital imply low flows of repatriated profits. However, the success in attracting FDI will increase this counter flow over the years, which could exceed the alternative flow of interest payments in the long run.

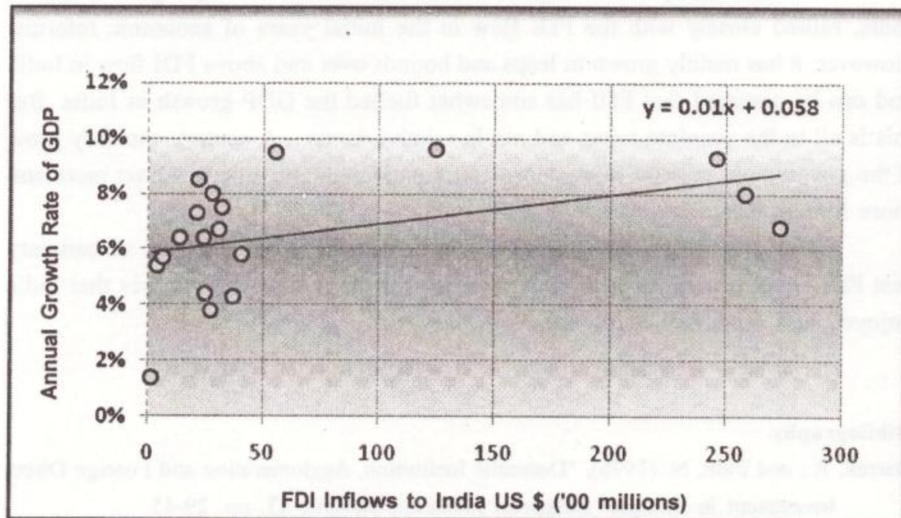
It is evidenced from the literature that the impact of FDI on the host economy can be adjudged from two effects of FDI on the economy. These two effects include the real effect and the financial effect. The real effect includes both qualitative and quantitative effects. The quantitative effects of FDI include the effects on the domestic investment, productivity, price level, income, and employment and export growth. The qualitative effects of FDI include the effects on technological change, spillover effects and the effects on structural change of the economy. The financial effects of FDI on the host economy are the impact (measurable) on balance of payments. The direction (forward or backward) of all these effects (both real and financial effects) as mentioned earlier, depends upon domestic policy, the kinds of FDI that a country receives the strength of domestic enterprises and the structure of the domestic economy.

FDI and economic growth generally points to a positive relationship between the two variables, and offers several, standard explanations for it. In principle, economic growth may induce FDI inflow when FDI is seeking consumer markets, or when growth leads to greater economies of scale and, hence, increased cost efficiency. On the other hand, FDI may affect economic growth, through its impact on capital stock, technology transfer, skill acquisition, or market competition. FDI and growth may also exhibit a negative relationship, particularly if the inflow of FDI leads to increased monopolization of local industries, thus, compromising efficiency and

growth dynamics.

Empirically, the positive effect of host country economic growth on FDI inflow has been confirmed by various studies (Veugelers, 1991; Barrell and Pain, 1996; Grosse and Trevino, 1996; Taylor and Sarno, 1999; Trevino et al., 2002). The effects of FDI on subsequent economic growth has been shown to be both positive (Dunning, 1993; Borensztein et al., 1998; De Mello, 1999; Ericsson and Irandoust, 2000; Trevino and Upadhyaya, 2003) and negative (Moran, 1998). Generally, the positive growth effects of FDI have been more likely when FDI is drawn into competitive markets, whereas negative effects on growth have been more likely when FDI is drawn into heavily protected industries (Encarnation and Wells, 1986). Overall, though, FDI turns out to be associated with greater domestic investment, not smaller. Moreover, this positive association between FDI and domestic investment tends to be greater than that between foreign portfolio investment and domestic investment (Bosworth and Collins, 1999).

Figure 3 : Scatter Plot of FDI Inflows Vs GDP Growth



Data Source : Economic Survey 2010-11

From the Regression Analysis it can be inferred that FDI in India has had a positive relationship with GDP of India and has fuelled the GDP growth of India. From the scatter plot, we can infer that GDP rallied closely on with the FDI flow in the initial years of economic reform, however, it has mainly grown in leaps and bounds over and above FDI flow in India. Hence, we can assume that FDI has somewhat fuelled the GDP growth in India. However, from this analysis it can be

proved to a certain degree of certainty that FDI is not one of the sole major reasons for the robust GDP figures that India enjoyed and continues to do so.

CONCLUSIONS

It is generally said that future is always uncertain. This saying is correct to some extent. But at the same time it is also said that exceptions are always there. This exception is about India's certain higher rate of growth in the present and the coming future. The future of Indian economy is brighter because of its huge human resources, rapidly upcoming service sector, availability of large number of competent professionals, vast market for every product, increasing impact of consumerism, absence of controls and licenses, interest of foreign entrepreneurs in India and existence of four hundred million middle class people. India's say in the international diplomacy and political affairs has now become meaningful, thousands of foreigners are working as executives in India, packages are becoming lucrative and competitive and annual rate of growth is highest after China.

The analysis performed gives some reflection on the GDP growth rate of India, rallied closely with the FDI flow in the initial years of economic reforms. However, it has mainly grown in leaps and bounds over and above FDI flow in India and can be assumed that FDI has somewhat fuelled the GDP growth in India. But this is all in the absolute sense and not in relative terms. A country can only grow if the government policies allow more participation and are able to attract more and more foreign direct investment in India.

However, from this analysis it can be proved to some degree of certainty that FDI is not one of the sole major reasons for the robust GDP figures that India enjoyed and continues to do so.

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