Tradeoff between Foreign Direct Investment and Economic Growth

*Gauri Modwel**

Abstract

The FDI mantra is considered an all-purpose panacea for the ills of the economy and society. Unfortunately, there has not been much debate about the far-reaching implications of FDI in Indian economy and, particularly, how it can stifle economic growth. The debate only focuses on the so-called effect on employment and loss of "socialism". This paper tries to counter to the five arguments in favour of FDI by citing some research findings.

Economic Growth Based on Domestic Savings

Fortunately India's economic growth over the last decade and a half has primarily been driven by savings in the economy, especially by households. Housewives from middle-class should be given due credit for this. The given Table shows the savings and investment rate in the economy and the gap being met by foreign flows.

Table : Saving and Investment as percent of Market Price

%

Parameters	1996-97	1999-200	2001-02	2002-03	2003-04	2004-05
Gross Domestic Savings	23.2	24.2	23.4	26.5	28.1	29.1
Gross Domestic Investment	24.5	25.3	22.6	24.8	26.3	30.1
Saving-Investment Gap	-1.3	-1.1	0.8	1.3	1.8	-1.0

Source : Economic Survey 2004-2005

* *Dr. Gauri Modwel*
Assistant Professor, NDIM

It can be observed from the analysis on the basis of given facts that all our investments have come from our own savings in the past decade. The argument pertaining to the need for FDI is based on the following premises:

Various research studies reflected that for sustainable growth of 10 per cent with capital-output ratio of 3.5 any developing economy need investment at 35 per cent and if savings rate is 29 per cent then the gap has to be met by the West. This is, to start with, spurious since the measurement of the capital-output ratio is not reliable and definitely not applicable to our service sector, which makes up nearly 60 per cent of the economy and its growth engine. Anyone who has traveled in a taxi in the North will know that there can be passengers to the right side of the driver and the actual capacity of our buses is infinite.

Made in China is not Made by China

The second argument is that China is getting so much FDI. In 2006 it is expected to have a net direct investment of $51 billion of the estimated $155 billion flows to emerging markets (Capital Flows in emerging markets by IIF, January 2006). The important and crucial point, missed by the China enthusiasts, is that China does not have a developed entrepreneurial class like India and, hence, it is dependent on the foreign capitalists and foreign capital compared to India, which has a burgeoning entrepreneurial class. Made in China is not same as made by China. India has a phenomenally well-developed capitalist class which can set up world-class automobile, steel, petrochemical and cement plants.

While India's stock market has soared in recent years, the opposite has happened in China. In 2001, the Shanghai Stock Market index reached more than 2,200 points; by April 2005, nearly half of it had gone, with the Shanghai index at 1,135 points. This sharp decline occurred when the GDP was growing at 9 per cent a year. It is difficult to find another country that displays this strange combination of excellent macroeconomic performance and dismal microeconomic performance. The reasons are to be found in the structure created by FDI, much of which is not even listed. China has to depend on foreign capital to set up its manufacturing facilities and is struggling hard to encourage party bureaucrats to become entrepreneurs.

Active capital market

The third argument is that FDI provides us with a continuous flow of funds and an active capital market. Actually, hundreds of MNCs have de-listed from the stock market in the last decade by converting to unlisted subsidiaries of foreign parents. An analysis of this alone will give a clue to the nature of the capital market due to foreign investment in our economy. A MNC does not even bring funding from outside sources since it can access funds in the domestic market by showing "comfort letters" from its parent company. There are many local financial institutions, both Government and private, which would lend them below prime rate since they are "global". Financial institutions in India do not deny foreigners funds. That the MNC will continuously bring funds from abroad is a statement which should be taken with tones of salt.

Technology Transfer

The fourth argument is regarding technology transfer. In this age of information flows and market for technology any entrepreneur can purchase technology needed by him. In a country like India, which scores very high for "technology diffusion" or "absorption", building on technology is not an issue. The Indian Diaspora can be relied upon to acquire most modern technology in complex areas, and there are already significant organic links between the NRIs and the domestic capitalists.

Is it a one-way street?

The fifth argument is regarding the growing global flow of funds and how nation-states cannot ignore it. Actually, given the demographic structure and growth of pension funds in Europe and the US, we can see that funds are in search of markets, and not the other way. It means India is in a position to choose whom to invite. But politicians would rather continue to "sell" India because it is an easy skill for most of politicians. Which sectors are "sold" globally for FDI in India? It is the retail trade, restaurants, road transport & construction and recent addition is education sector. Non-corporate, family-run businesses dominate all these activities.

In most of these sectors the share of partnership/proprietorship firms is more than 80 per cent. The main concern is that global corporates should come into India and turn these millions of entrepreneurs into workers. Can there be anything more perverse than this? What they need is adequate credit at reasonable rates and less bribes demanded by government minions. What additional technological wonders will be wrought by FDI in these areas?

Conclusion

It may be tempting to conclude that the pre-reform approach to FDI in India was not so bad after all. Traditionally, selective appròval procedures and performance requirements were meant to promote FDI in technologically advanced and more export-oriented manufacturing industries, and to discourage FDI in the tertiary sector where foreign investors might replace local service providers. However, such a conclusion would be misconceived. FDI in India rests on weak empirical foundations.

On an on average, 90 per cent of the stock of capital in developing countries is self-financed, and this fraction was surprisingly stable throughout the 1990s. More importantly, it is being observed that "there is no evidence of any "growth bonus" associated with increasing the financing share of foreign savings. In fact, the evidence suggests the opposite: throughout the 1990s, countries with higher self-financing ratios grew significantly faster than countries with low self-financing ratios. (As per findings of study conducted by National Bureau of Economic Research NBER)

More interestingly, it is found that the higher volatility of the self-financing ratios are associated with lower growth rates, and that better institutions are associated with lower volatility of the self financing ratios. It completely negates the FDI mantra chanted day in and day out by India's metropolitan elite. But so will anybody heed any empirical analysis or logic available on this score? Actually it paralyses ability to think straight and makes us crave, like a drug addict, the opium of FDI.

References:

1. Aizenman Joshua, Pinto Brian, Radziwil Artur (2004). Sources for financing domestic capital: Is foreign saving a viable option for developing countries?" Working Paper, National Bureau of Economic Research (NBER), June 2004

2. A Comparative Case Study of China, Mexico and India. In: R.K. Sen (ed.), *Socio-Economic Development in the 21st Century*. New Delhi (Deep & Deep): 257-288.

3. Agrawal, R., and R. Shahani (2005). Foreign Investment in India: Issues and Implications for Globalisation. In: C. Tisdell (ed.), *Globalisation and*

4. Alfaro, L. (2003). Foreign Direct Investment and Growth: Does the Sector Matter? Harvard Business School, Boston, MA, mimeo.

5. Alfaro, L., A. Chanda, S. Kalemli-Ozcan, S. Sayek (2001). FDI and Economic Growth: The Role of Financial Markets. Working Paper 01-083, Harvard Business School, Boston, MA.

6. Arabi, U. (2005). Foreign Direct Investment Flows and Sustained Growth: A Case Study of India and China. Paper for DEGIT conference in Mexico City, mimeo.

7. Institute of International Finance: Report on *"Capital Flows in Emerging Market Economies"*, May 2006.

8. Government Of India, *Economic Survey* (2005-06), Ministry of Finance