Impact of Foreign Direct Investment On Indian Economy

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ABSTRACT

In Indian economy, Foreign Direct Investment has generated a lot of euphoria. Foreign direct investment (FDI) has been one of the defining features of the world economic system during the final two decades. The purpose of this paper is to provide an overview of the impact of foreign direct investment in Indian economy. Since 1991, after the introduction of LPG the flow of foreign direct investment (FDI) rapidly spread out across India; this increase was induced by an increase in mergers and acquisitions activities. This trend is gaining force, as Indian Government started to ask a question: "What is the impact of FDIs in our country's enduring economic growth?" Whereas the traditional and the purchasing power theory had it that "FDI could become the engine of growth for India through the transfer and diffusion of knowledge", there is now an increasing need to assess this claim by finding out the growth trend of FDI in India. This research report proposes to study the impact of FDI on the Indian economy, especially after two decades of economic reforms, and breaks down the challenges to position itself favorably in the worldwide competition for FDI.

Key words: Economy, FDI, FII, Reforms, Services.

I - INTRODUCTION

FDI plays a very significant role in the economic development of developing countries like India. It promotes an open business climate, builds technologies and advance employee training, besides helping Government revenue to grow. FDI inflow in the last 2 decades, stimulated by globalization and liberalization of the Indian economy has played a complementary role in filling the gap between domestic investment and saving. It is a preferred source of external finance for the simple reason that they are not debt, creating, non volatile in nature and their returns depend upon the projects financed by the investor. According to International Monetary Fund (IMF), FDI is defined as " an investment that is made to acquire a lasting interest in an enterprise operating in a economy other than that of the investor" The investor's purpose is to have an effective voice in the management of the enterprise (IMF,1977).FDI is the process by which the residents of one country (the so (P.M, 2012) acquire the ownership of assets for the purpose of controlling the production, distribution and other productive activities of a firm in another country (the host country). FDI is permitted under the following forms of investments: through financial collaborations, through joint ventures and technical collaborations, through capital markets via Euro issues and through private placements or preferential allotments. (H, 2011) Apart from being a critical driver of economic growth, foreign direct investment (FDI) is a major source of non-debt financial resource for the economic development of India. Foreign companies invest in India to take advantage of relatively lower wages, special investment privileges such as tax exemptions, etc. In a country where foreign investments are being made, it also means achieving technical know-how and generating employment.

The Indian government's favorable policy regime and robust business environment have ensured that foreign capital keeps flowing into the country. The government has taken many initiatives in recent years such as relaxing FDI norms across sectors such as defense, PSU oil refineries, telecom, power exchanges, and stock exchanges, among others. (India brand equity foundation, 2016) (Satinder Palaha, 1996)

II - FDI AND ECONOMIC GROWTH IN INDIA

The historical background of FDI in India can be traced back to the establishment of the East India Company of Britain. British capital came to India during the colonial era of Britain in India. After Second World War, Japanese companies entered the Indian market and enhanced their trade with India, yet U.K. remained the most dominant investor in India. Further, after Independence issues relating to foreign capital, operations of MNCs, gained attention of the policy makers. Keeping in mind the national interests the policy makers designed the FDI policy which aims FDI as a medium for acquiring advanced technology and to mobilize foreign exchange resources. With time and as per economic and political regimes there have been changes in the FDI policy too. The industrial policy of 1965, allowed MNCs to venture through technical collaboration in India. Therefore, the government adopted a liberal attitude by allowing more frequent equity. In the critical face of Indian economy the government of India with the help of the World Bank and IMF introduced the macro-economic stabilization and structural adjustment program. As a result of these reforms India open its door to FDI inflows and adopted a more liberal foreign policy in order to restore the confidence of foreign investors. Further, under the new foreign investment policy Government of India constituted FIPB (Foreign Investment Promotion Board) whose main function was to invite and facilitate foreign investment Starting from a baseline of less than USD 1 billion in 1990, a recent UNCTAD survey projected India as the second most important FDI destination (after China) for transnational corporations during 2010-2012. As per the data, the sectors which attracted higher inflows were services, telecommunication, construction activities and computer software and hardware. Mauritius, Singapore, the US and the UK were the leading sources of FDI to the country. (Malhotra, 2014)

III - PROHIBITION ON FDI IN INDIA

FDI is prohibited in the following activities/sectors : Retail Trading (except single brand product retailing) Lottery Business including Government /private lottery, online lotteries etc, Gambling and Betting including casinos etc. Business of chit fund

Nidhi company.

Trading in Transferable Development Rights (TDRs). Real Estate Business or Construction of Farm Houses. Manufacturing of Cigars, cheroots, cigarillos and cigarettes, of tobacco or of tobacco substitutes. Activities / sectors not opened to private sector investment, including Atomic Energy and Railway Transport (other than Mass Rapid Transport Systems).

IV - DETERMINANTS OF FDI

The determinant varies from one country to another due to their unique characteristics and opportunities for the potential investors. In specific the determinants of FDI in India are

* Stable Policies: India stable economic and social policies have attracted investors across the border. Investors prefer countries which stable economic policies. The government makes changes in policies which will have an effect on the business. The business requires a lot of funds to be deployed and any change in policy against the investor will have a negative effect.

* Economic Factors: Different economic factors encourage inward FDI. These include interest loans, tax breaks, grants, subsidies and the removal of restrictions and limitation. The government of India has given many tax exemptions and subsidies to the foreign investors who would help in developing the economy.

* Cheap And Skilled Labor: There is abundant labor available in India in terms of skilled and unskilled human resources. Foreign investors will take advantage of the difference in the cost of labor as we have cheap and skilled laborers. Example: Foreign

firms have invested in BPO's in India, which require skilled labor and we have been providing the same.

Basic Infrastructure: India though is a developing country, it has infrastructure such as roads, effective transportation and registered carrier departures worldwide, Information and communication network/technology, powers, financial institutions, and legal system and other basic amenities which are must for the success of the business.

Unexplored Markets: In India there is large scope for the investors because there is a large section of markets have not explored or initialized. In India there is an enormous potential customer market with large middle class income group who would be a target group for new markets. Example: BPO was one sector where the investors had a large scope, exploring the markets where the service was provided with just a call, with almost customer satisfaction.

Availability of Natural Resources: As we that India has a large volume of natural resources such as coal, iron ore, Natural gas, etc. If natural resources are available they can be used in the production process or for extraction of mines. (P.M, 2012)

V - CHALLENGES AND IMPROVEMENT AREAS

India is definitely a lucrative place for FDI, but there are certainly some challenges and areas for improvement still present. Until, these areas are honed to perfection, India will not become the number one place for FDI. India is focusing on maximizing political and social stability along with a regulatory environment. In spite of the obvious advantages of FDIs, there are quite a few challenges facing larger FDIs in India, such as:

* Resource challenge: India is known to have huge amounts of resources. There is a manpower and significant availability of fixed and working capital. At the same time, there are some underexploited or unexploited resources. The resources are well available in the rural as well as the urban areas. The focus is to increase infrastructure 10 years down the line, for which the requirement will be an amount of about US$ 150 billion. This is the first step to overcome challenges facing larger FDI.

* Equity challenge: India is definitely developing at a much faster pace now than before, but in spite of that it can be identified that developments have taken place unevenly. This means that while the more urban areas have been tapped, the poorer sections are inadequately exploited. To get the complete picture of growth, it is essential to make sure that the rural section has more or less the same amount of development as the urbanized ones. Thus, fostering social equality and at the same time, a balanced economic growth.

* Political Challenge: The support of the political structure has to be there towards the investing countries abroad. This can be worked out when foreign investors put forward their persuasion for increasing FDI capital in various sectors like banking, and insurance. So, there has to be a common ground between the Parliament and the foreign countries investing in India. This would increase the reforms in the FDI area of the country.

* Federal Challenge: Very important among the major challenges facing larger FDI, is the need to speed up the implementation of policies, rules, and regulations. The vital part is to keep the implementation of policies in all the states of India at par. Thus, asking for equal speed in policy implementation among the states in India is important.

* India must also focus on areas of poverty reduction, trade liberalization, and banking and insurance liberalization. Challenges facing larger FDI do not just restrict to the ones mentioned above, because trade relations with foreign investors will always bring in new challenges in investments (Malhotra, 2014)

VI - GOVERNMENT INITIATIVES

The Government of India has amended the FDI policy regarding Construction Development Sector. The amended policy includes easing of area restriction norms, reduction of minimum capitalization and easy exit from the project. Further, in order to provide a boost to low cost affordable housing, it has indicated that conditions of area restriction and minimum capitalization will not apply to cases committing 30 per cent of the project cost towards affordable housing.

The Government of India has recently relaxed foreign direct investment (FDI) policy in 15 sectors, such as raising the foreign investment limit for some sectors, easing the conditions for others and putting money on the automatic route for approval. The sectors that benefited from the relaxation include defense, real estate, private banking, defense, civil aviation, single brand retail and news broadcasting. The new rules provide for easier exit from an investment in the construction sector while the foreign investment limit in defense and airlines was allowed up to 49 per cent through the automatic route. Banks were allowed fungible FDI investment up to 74 per cent, which means that FII investment in private banks can rise to this limit.

The Government of India recently relaxed the FDI policy norms for Non-Resident Indians (NRIs). Under this, the non-reparable investments made by the Persons of Indian Origin (PIOs), Overseas Citizens of India (OCI) and NRIs will be treated as domestic investments and will not be subject to FDI caps.

The government has also raised the FDI cap in insurance from 26 per cent to 49 per cent through a notification issued by the DIPP. The limit is composite in nature as it includes foreign investment in the form of foreign portfolio investment, foreign institutional investment, qualified foreign investment, foreign venture capital investment, and non-resident investment.

The Cabinet Committee on Economic Affairs (CCEA) has raised the threshold for foreign direct investment requiring its approval to Rs 3,000 crore (US$ 469 million) from the present Rs 1,200 crore (US$ 187 million). This decision is expected to expedite the approval process and result in increased foreign investment inflow.

India's cabinet cleared a proposal which allows 100 per cent FDI in railway infrastructure, excluding operations. Though the initiative does not allow foreign firms to operate trains, it allows them to invest in areas such as creating the network and supplying trains for bullet trains etc.

India is likely to grant most favored nation (MFN) treatment to 15 countries that are in talks regarding an agreement with the Regional Comprehensive Economic Partnership (RCEP), which would result in significant easing of investment rules for these countries.

The Government of India plans to further simplify rules for Foreign Direct Investment (FDI) such as increasing FDI investment limits in sectors and include more sectors in the automatic approval route, to attract more investments in the country. (India brand equity foundation, 2016)

Road ahead

According to United Nations Conference on Trade and Development (UNCTAD) World Investment Report 2015, India acquired ninth slot in the top 10 countries attracting the highest FDI in 2014 as compared to 15th position last year. The report also mentioned that the FDI inflows to India are likely to exhibit an upward trend in 2016 on account of economic recovery. India also jumped 16 notches to 55 among 140 countries in the World Economic Forum's Global Competitiveness Index that ranks countries on the basis of parameters such as institutions, macroeconomic environment, education, market size and infrastructure among others.

VII - CONCLUSIONS

Liberalization of rules for equity caps, investment reviews and other provisions that have impeded India's ability to attract even more foreign investment over the recent years. India is the only country in South Asia, where FDI inflows have fallen during 2010. A major reason for the decline in inward FDI is reported to have been the environment, sensitive policies pursued, as manifested in the recent episodes in the mining sector, integrated township projects and construction of ports, which appear to have affected the investors' sentiments.

Added to this is the persistent procedural delays, land acquisition issues and availability of quality infrastructure, which remain at the center of the Government's policy focus. These factors, which are more structural in nature, if addressed expeditiously, could raise the share of India in the projected FDI flows in the near future.

There is a strong likelihood of substantial growth in foreign investment once equity caps are phased out and eliminated as companies increasingly want to exercise greater day to day control over their investments. For sectors in which no equity caps currently exist, it is strongly believed to discourage the imposition of such caps. A move in this direction is incongruous with the Indian Government's interest in promoting investment and accelerating economic development.

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