ISSN (Online) 2394-6849

International Journal of Engineering Research in Electronics and Communication Engineering (IJERECE)
Vol 5, Issue 2, February 2018

Foreign Direct Investment: It's Impact on Developing Countries Economy - A Study of India

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Abstract: - **Foreign direct investment (FDI) is considered to be one of the important factors, which leads to the globalization of an economy. The globalization over the last two decades has been hailed as a major development, which results in economic prosperity in developing countries. In this paper, we have attempted to identify the Determinants, impact and problems associated with India's current foreign direct investment regime, and more importantly the other associated factors responsible for India's unattractiveness as an investment location. The presence of a large domestic market, fairly well developed financial architecture and skilled human resources, it can attract much larger foreign investments than it has done in the past. India's present international investment regime facilitates easy entry of foreign capital in almost all areas subject to specific limits on foreign ownership. Entry options have not only become procedurally simpler, but prospects for higher yields from investment have also become brighter. But the further boost to Foreign Direct Investment (FDI) will depend significantly on further liberalization of its foreign investment regime. The paper provides the brief synthesis of the regime and analyzes the economic and policy variables as the important determinants of FDI inflows to India.**

Keywords: - **Foreign Direct Investment (FDI), Foreign Portfolio Investment (FPI), Gross Domestic Product (GDP), Economic Policy Reform.**

I. INTRODUCTION

India is the largest democracy and fourth largest economy in terms GDP in the world. With its consistent growth performance and high-skilled manpower, India provides enormous opportunities for foreign investment. Since the beginning of economic reforms in 1991, major reform initiatives have been taken up in the field of investment, trade and financial sector. Enactment of Competition Act, liberalization of Foreign Exchange Management Act (FEMA), and amendments in Intellectual Property Right (IPR) laws and many other initiatives make India attractive for business. India is the second most attractive foreign Direct Investment destination (A.T. Kearney 2007). Also it is the second most attractive destination among transnational Corporations for 2007- 09 (UNCTAD's World Investment Report, 2007). Though inflows have responded positively to policy changes by increasing from US$ 165 million in 1990-1991 to US$ 90 billion in 2008-2009, there might have been much more had foreign investment not been regulated in some key areas. Till the 1990s the policy was heavily restrictive with majority foreign equity permitted only in a handful export- oriented, high technology industries. Initiated reforms changed the perceptions of foreign investors with foreign investment policy becoming progressively liberal following steady withdrawal of external capital controls and simplification of procedures. While India has an overall market-friendly and liberal policy towards foreign investment, foreign capital still does not enjoy equally easy access in all parts of the economy. The manufacturing sector is still untapped accompanied by lack of access in certain services and agriculture. India's future foreign investment policy faces the critical challenge of increasing access of foreign capital to these segments. Foreign Direct Investment is now recognized as an important driver of growth in the country. Government is making all efforts to attract and facilitate and investment from Non Resident (NRIs) including Overseas Corporate Bodies (OCBs) that are predominantly owned by them, to complement and supplement domestic investment According to the International Monetary Fund (IMF), a has three components, namely equity capital, reinvested earnings and other direct capital. A large number of countries, including several developing countries, report inflows in accordance with the IMF definition. However, the Reserve Bank of India (RBI) reports inflows only on the basis of investments received from non-residents on equity and preference share capital under the scheme. One of the most striking developments during the last two decades is the spectacular growth of in the global economic landscape. This unprecedented growth of global in 1990 around the

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world make an important and vital component of development strategy in both developed and developing nations and policies are designed in order to stimulate inward flows. In fact, provides a win – win situation to the host and the home countries. Both countries are directly interested in inviting, because they benefit a lot from such type of investment. The 'home' countries want to take the advantage of the vast markets opened by industrial growth. On the other hand the 'host' countries want to acquire technological and managerial skills and supplement domestic savings and foreign exchange. Moreover, the paucity of all types of resources viz. financial, capital, entrepreneurship, technological know- how, skills and practices, access to markets- abroad- in their economic development, developing nations accepted as a sole visible panacea for all their scarcities. Further, the integration of global financial markets paves ways to this explosive growth of around the globe.

1.1. Evolution of the study in India

The historical background of in India can be traced back with the establishment of East India Company of Britain. British capital came to India during the colonial era of Britain in India. However, researchers could not portray the complete history of pouring in India due to lack of abundant and authentic data. Before independence major amount of came from the British companies. British companies setup their units in mining sector and in those sectors that suits their own economic and business interest.

After Second World War, Japanese companies entered 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 policy which aims as a medium for acquiring advanced technology and to mobilize foreign exchange resources. The first Prime Minister of India considered foreign investment as "necessary" not only to supplement domestic capital but also to secure scientific, technical, and industrial knowledge and capital equipments. With time and as per economic and political regimes there have been changes in the policy too.

The industrial policy of 1965, allowed MNCs to venture through technical collaboration in India. However, the country faced two severe crisis in the form of foreign exchange and financial resource mobilization during the second five year plan (1956-61). Therefore, the government adopted a liberal attitude by allowing more frequent equity participation to foreign enterprises, and to accept equity capital in technical collaborations. The government also provides many incentives such as tax concessions, simplification of licensing procedures and de- reserving some industries such as drugs, aluminum, heavy electrical equipments, fertilizers, etc in order to further boost the inflows in the country. This liberal attitude of government towards foreign capital lures investors from other advanced countries like USA, Japan, and Germany, etc. But due to significant outflow of foreign reserves in the form of remittances of dividends, profits, royalties etc, the government has to adopt stringent foreign policy in 1970s. During this period the government adopted a selective and highly restrictive foreign policy as far as foreign capital, type of and ownerships of foreign companies was concerned.

Government setup Foreign Investment Board and enacted Foreign Exchange Regulation Act in order to regulate flow of foreign capital and flow to India. The soaring oil prices continued low exports and deterioration in Balance of Payment position during 1980s forced the government to make necessary changes in the foreign policy. It is during this period the government encourages, allow MNCs to operate in India.

Thus, resulting in the partial liberalization of Indian Economy. The government introduces reforms in the industrial sector, aimed at increasing competency, efficiency and growth in industry through a stable, pragmatic and non-discriminatory policy for flow. In fact, in the early nineties, Indian economy faced severe Balance of payment crisis. Exports began to experience serious difficulties.

There was a high increase in petroleum prices because of the gulf war. The crippling external debts were debilitating the economy. India was left with that much amount of foreign exchange reserves which can finance its three weeks of imports. The out flowing of foreign currency which was deposited by the Indian NRI's gave a further surprise to Indian economy. The overall Balance of Payment reached at Rs.(-) 4471 crores. Inflation reached at its highest level of 13%. Foreign reserves of the country stood at Rs.11416 crores. The continued political uncertainty in the country during this period adds further to worsen the situation. As a result, India's credit rating fell in the international market for both short- term and long term borrowing. All these developments put the economy at that time on the edge of default in respect of external payments liability. In this critical face of Indian economy the then finance Minister of India Dr. Manmohan Singh with the help of World Bank and IMF introduced the macro – economic stabilization and structural adjustment programme.

As a result of these reforms India open its door to 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 through single window system from the Prime Minister's

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Office. The foreign equity capital was raised to 51 percent for the existing companies. Government had allowed the use of foreign brand names for domestically produced products which was restricted earlier. India also became the member of MIGA (Multilateral Investment Guarantee Agency) for protection of foreign investments.

1.2. Description of the Problem

The heavy reliance of the Indian economy on external debt in the financial year 1990- 91 due to severe balance of payment crisis led international credit rating agencies to lower India's rating both for short and long-run borrowing. This made borrowing in international commercial markets difficult and also led to an outflow of foreign currency deposits kept in India by the NRIs. The situation was made worse by the Gulf war, which resulted in an increase in petroleum prices and caused virtual stoppages of remittances from Indian workers in the Gulf These developments brought the country almost to the verge of default in respect of external payments liability. As this critical juncture, the then Finance Minister Manmohan Singh scripted a new chapter in the history of Indian economy by initiating a programme of macro-economic stabilization and structural adjustment supported by the World Bank. An economy, which was not considering foreign aliment favorably, tried to mingle itself with the world economy that was hit by the wave of globalization. As a result of this, flows into India increased significantly into the 1995. The compound growth rate of was 4 per cent during 1955-66, which rose to 75 per cent during 1991-98. Therefore, it is going to be a prominent force in the: Macroeconomic Policy and Growth of the Indian economy. However, the inflows into India have been very low as compared to other developing countries like China, Brazil, :Y1exico, Thailand and Korea. The share of the FDl inflows into India as against the total inflows to the developing countries is only 1.2 percent (RBI 1998), Keeping the positive effects and importance of flows, it is necessary to analyze the reasons for low inflows into India. In this context, it is important to analyze the determinants of FDl inflows both at macro and sectoral levels. As argued earlier, can play a vital role as a source of capital, management, and technology in India. can also fill the gap between desired investment and locally mobilized savings (Blomstrom and Kokko 1997). Local capital markets are not well developed. Thus, they cannot meet the capital requirements for large investment projects. Besides, access to hard currency needed to purchase investment goods is not possible locally. FDI solves both these problems at once, as it is a direct source of external capital. Also can fill the gap between desired foreign exchange requirements and those derived from net export earning (Fry 1993). This can be done since the will bring currency in the foreign denomination and as a result the forex reserve of the domestic country will go up.

FDI can create employment in the modem sectors of the developing countries like India (Lahiri and Ono 1998), if the host country forces a domestic content requirement on the foreign limits. In this case, the foreign firms have to employ the unemployed and underemployed resources of the host & domestic country. As the foreign limits are expected to reduce the set up cost in the less efficient host countries by bringing in better technology and knowhow, the prices would go down. In the light of this, the consumers in these countries can benefit through lower prices and improved quality of goods. FDI can stimulate domestic investment through and backward linkages (Glass and Saggi 2001). Output of a foreign limits can be an input of the domestic industry and vice versa. If this is so, the FDI can create demand for the products of industries producing goods purchased. This would lead to an increase in the up stream and down stream domestic investment in the host country.

The adverse implications of those, when is competitive with home investment, and the profit in the domestic industries falls, leading to a fall in the domestic savings The contribution of foreign firms to public revenue through corporate taxes is arguably less because of liberal tax concessions, excessive investment allowances. Disguised public subsidies and tariff protection provided by the host government. Foreign firms reinforce dualistic socio-economic structure and increase income inequalities. They create a small number of highly paid modem sector executives and divert resources away from priority sectors to the manufacture of conspicuous consumption for the elites. Added to all these problems, the out now of profit is too large in many cases, putting pressure on the foreign exchange reserves. Moreover, the repatriation of profit by foreign firms may drain out the capital from the Indian economy. In this context, there is a need to study the impact of inflows both at the macro as well as at the sectoral levels.

It can be observed from the fact that highlights the possibility of substantial opportunities as well as considerable dangers. Therefore, the main objective of this present study is to examine both the negative and positive impact on the Indian economy and suggest policy measures for promoting higher inflows, which may make a significant contribution to the economic growth in India.

1.3 Empirical Review of the Study

Empirical studies have been grouped according to the theoretical issues they deal with. In the empirical literature, market size and growth rate of the market are considered as the major determinants The earlier studies emphasize that a big market size of the host economy would attract foreign firms to produce in the economy whereas the small market size of the home country of the MNCs would induce the firm to go out for overseas production. However, it is also argued that if an economy grows at a faster rate. It would attract more foreign firms and bring more FDI. In this case, the growth rate of the economy is a better indicator of the demand than the simple size of the economy (Wang and Swain 1995). Lucas (1993) and Jun and Singh (1996) have argued that in addition to the size of the domestic market in the host country, also depend on export markets.

Though the market size hypothesis argues that inward is a function of the size of the host country market, many export-oriented countries attract more as they serve the export market of the product. Thus, if host country's firms are export oriented, these firms attract: MNCs who are interested in exporting that product.

However, the study by Kumar (1990) for the Indian economy does not support this view. Kravis and Lipsey (1982) and Chen (1992) identify import as the important determinant of the MNC activities. It is based on the Kojima hypothesis as they argue that the MNCs activities could be affected by the import from the host country. In this case, the import of the host country would appear in the cost determinant of the as high import intensity of the host nation would deter the FDI inflows into that economy.

A set of studies have proposed that tax incentives are less likely to attract foreign investors, whose production is primarily for the domestic market (Root and Ahmed 197R, Jun 1989). These studies argue that for prospective investors, whose investment is oriented towards the local market, the degree of protection is often a crucial determinant of the decision to invest or not to invest and is of far greater concern than tax holidays.

The empirical literature on the impact of supports the dichotomous view on the impact of .Chenery and Strout (1966) state that foreign assistance was the striking force for the rapid and sustained growth by countries like Greece, Israel, Taiwan and the Philippines during the 1950s. Kamath (1990) has stated that made substantial impact in modernizing Chinese industries including the transfer of low and intermediate technology, managerial expertise and marketing knowledge.

The empirical study of Karikari (1992) for Ghana economy doesn't support the view that leads 10 economic growth. Further, the cross-sectional study of Shamsuddin (1994) for developed and less developed countries finds negative correlation between and economic growth. Wang (1995) explains growth differentials among Chinese urban areas due to that produced technological spillover in China, The study also states that the growth differentials in Chinese urban areas could be attributed to the differentials in the flows of to the regions. However, the empirical study for the U.S by Kashibhatla and Sawhney (1996) supports a unidirectional causality from GDP to FDI, not the reverse. This might be due to the fact that for a developed country, followed GDP, as GDP was an indicator for market size. Sashir (1999) has examined the relationship between and growth empirically in some MENA countries, using panel data. The study finds that FDI lead to economic growth; the effect, however, varied across regions and over time.

II. CONCLUSION

The major findings of the study at the macro level suggest that FDI played a vital role in the economic growth of the country. it also contributed significantly to raise the capital formation in India. The global share of the FDI inflow in India is very low, it is able to take the overall economy in a positive direction. in this context, the FDI inflow is very important and should be encouraged significantly in all spheres of the Indian economy. It is also important to note that FDI inflow in the country has also not been able to fulfill the objective of increasing exports and saving. In the case of export promotion through FDI inflow, it is suggested to reduce the tariff rates of the country.

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