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Role of Foreign Direct Investment (Fdi) in India's Economic Development-An Analysis

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Abstract

Foreign Direct Investment (FDI) plays an important role in global business. It can provide a firm with new marketing channels, cheaper production facilities, access to technology transfer, product, skills and financing. With the advent of globalization and strong governmental support, foreign investment has helped the Indian economy grow tremendously. India has continuously sought to attract investment from the world's major investors. In 1998 and 1999, the Government of India announced a number of reforms designed to encourage and promote a favorable business environment for investors. Foreign investments in the country can take in the form of investments in listed companies i.e., Foreign Institutional Investors'(FIIs) investments, investments in listed/unlisted companies other than through stock exchanges i.e., through the foreign direct investment or private equity/foreign venture capital investment route, investments through American Depository Receipts (ADR), Global Depository Receipts (GDR), or investments by Non-Resident Indians (NRIs) and Persons of Indian Origin (PIOs) in various forms. This paper attempts to review the importance of foreign direct investments in Indian economy, particularly after a decade of economic reforms and analyze the role played by the FDI in the economic development of the country. The study is diagnostic and exploratory in nature and makes use of secondary data. The study finds and concludes that the foreign direct investment in India have significantly improved and developed the economy as well.

Keywords: Foreign Direct Investment, Economy, Gross Domestic Product, Exports, and Foreign Exchange Reserves

I. Introduction

The history of foreign investment in India can be traced back with the establishment of East India Company of Britain. British capital came into India during the colonial era of Britain in India. Before independence, major amount of foreign investment came from the British companies.

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British companies setup their units in mining sectors and in those sectors that suit 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. Keeping in mind the national interests, the policy makers designed the Foreign Direct Investment (FDI) policy which aims FDI as a medium for acquiring advanced technology and to mobilize foreign exchange resources.

Foreign Direct Investment (FDI) means an investment through which the non-resident investor and foreign company can start a new company can acquire an effective share in an existing company in India with the specific objective of carrying on industrial activities or business in India.

The need for foreign capital for a developing country like India could arise on account of the following reasons:

a) Domestic capital is inadequate for purpose of economic growth and it is necessary to invite foreign capital.
b) For want of experience, domestic capital and entrepreneurship may not flow into certain lines of production. Foreign capital can show the way for domestic capital.
c) There may be potential savings in a developing economy like India but this may come forward only at a higher level of economic activity. It is, therefore, necessary that foreign capital should help in speeding up economic activity in the initial phase of development.
d) It may be difficult to mobilize domestic savings for the financing of projects that are badly needed for economic development; the capital market is itself underdeveloped. During the period in which the capital market is in the process of development, foreign capital is essential as a temporary measure.
e) Foreign capital brings with it other scarce productive factors, such as technical know-how, business experience and knowledge which are equally essential for economic development.

II. Statement of the Problem

Foreign investment is an important economic process during which foreign state and private companies and enterprises invest capital, technology and innovations into the companies of another country.

As usual, the capital flows from developed countries to developing countries. Modern world economy cannot develop successfully without foreign investment. A great number of countries invest their funds to the economy of other countries having a certain income and developing certain branches of industries of such countries. Due to received capital the country receives an opportunity to renew and develop all necessary branches of industries, to increase the effectiveness of production and produce competitive goods and services. Foreign investment is a predominant and vital factor in influencing the global economic development. Foreign investment has been defined as "a transfer of funds or materials from one country (called capital exploring country) to another country (called host country) in return for a direct or indirect participation in the earnings of that enterprise. Hence, this study is pertinent to analyze the impact of FDI inflows in the economic development of India.

III. Objectives of the Study

In order to appreciate the importance of foreign direct investment for the Indian economy, it would be pertinent to examine the changes in the global FDI flows and the place of India within. In this respect the objectives of the study are;

1) To review the Foreign Direct Investments secured by the country;
2) To analyze the trends of Foreign Direct Investment;
3) To assess the impact of the FDI in the economic development of a country;
4) To offer suggestion for the improvement of the FDI for the economic development of the country.

IV. Review of Literature

A considerable amount of research has been done on the working and performance of FDIs in India, by academicians and researchers.

The literature obtained by investigators, in the form of reports of various committees, commissions and working groups established by the Union Government, the research studies, articles of researchers, is briefly reviewed in this part.

Stanley Morgan (2002) has examined in his paper that FIIs have played a very important role in building up India's Forex Reserves, which have enabled a lot of economic reforms.

Lin et al. (2006) concluded that the investment performance of FIIs high holding stocks is significantly better than that of FIIs low holding stocks. They presented the evidence that FIIs trading behavior has generated better returns and portfolio performance since the stock market's full liberalization.

Douma, Pallathiatta and Kabir (2006) in their study investigated the impact of foreign institutional investment on the performance of emerging market firms and found that there is positive effect of foreign ownership on firm performance. They also found the impact of foreign investment on the business group affiliation of firms.

Krishna Prasanna (2008) in his study examined the relationship between foreign institutional investment and firm specific characteristics in terms of ownership structure, financial performance and stock performance.

Sumana Chatterjee (2009) in his dissertation investigated different aspects of FDI at the macroe-conomic level using aggregated data of FDI.

Sapna Hooda (2011) in her dissertation analysed the trends and patterns of FDI flows at world level.

Sarbapriya Ray (2012) in his study assessed empirically the relationship between Foreign Direct Investment (FDI) and economic growth in India using annual data over the period of 20 years from1990-91 to 2010-2011.

Rahul Dhiman (2012) in his study concluded that FII do have significant impact on the Indian Stock Market but there are other factors like government policies, budgets, bullion market, inflation, economical and political condition etc., also having an impact on the Indian Stock Market.

Arshad Muhammad (2012) attempted to investigate the long-run co-integrating relation among FDI, GDP, Export and Import for Pakistan.

V. Methodology

Methodology describes the research route to be followed, the instruments to be used, universe and sample of the study for the data to be collected, the tools of analysis used and pattern of deducing conclusions. The study carried out is an analytical and empirical in nature in which it explores the relationship between the inflows of FDI and their impact on Indian Economy.

Nature and Sources of Data

The present study is of analytical nature and makes use of secondary data. The relevant secondary data are collected from the following sources:

Publications of Government of India;
Publications of Reserve Bank of India;
Handbook of Statistics on the Indian Economy, RBI, Various Issues;
Economic Survey, Government of India, Various Issues;
Department of Industrial Policy and Promotion (DIIP);
Central Statistical Organization (CSO);
Investment Report 2009 Published by UNCTAD etc.
Various FDI related journals have also been referred to.

Tools Used for Analysis

The analysis of the data forms the core part of the research. In order to analyze the data and draw conclusions on this study, various statistical tools like growth rates, regression and correlation have been used through EXCEL and SPSS Software.

Period of the Study

The study period is ten years, starting from the year 2003-04 to 2012-13.

Limitations of the Study

The study, as limitations, is confined only to review and analyze the selected indicators for the period of ten years.

VI. Analysis and Discussion

1. Inflow of Foreign Direct Investment and Exports

Foreign Direct Investment is playing a very dominant role in the development of an economy in developing countries. With the help of an increasing trend of FDI inflows, the country's export has increased year after year. The year-wise inflows of FDI secured by the country along with the amounts of exports are furnished in Table 1.

Table-1: Year-wise Inflow of FDI and Export (US$ in Millions)

Years	FDI Inflows	% of Growth	Export	% of Growth
2003-04	4,322	--	63,842.60	--
2004-05	6,051	40.00	83,535.90	30.85
2005-06	8,961	48.09	103,090.50	23.41
2006-07	22,826	154.72	126,414.10	22.62
2007-08	34,843	52.64	162,904.30	28.87
2008-09	41,873	20.17	185,295.00	13.74
2009-10	37,745	-9.85	178,751.40	-3.53
2010-11	34,847	-7.67	251,136.20	40.49
2011-12	46,556	33.60	305,963.90	21.83
2012-13	36,860	-20.82	300,570.60	-1.76
CAGR	**23.90%**	--	**16.76%**	--

Source: DIPP and Reserve Bank of India, 2013.

The above Table-1 reveals that the FDI inflows and the Exports made by the country is increasing year after year. The FDI inflows has increased from 4,322 US$ million in 2003-04 to 36,860 US$ million in 2012-13. The increase over the period was 8.5 times. During the study period, the percentage of growth over the previous year lies between -20.82% and 154.72%. The highest growth rate has been observed (154.72%) in 2006-07. The lowest growth rate has been registered (-20.82%) in the year 2012-13.

Further, it is observed from the table that the export has also increased from 63,842.60 US$ million in 2003-04 to 3, 00,570.60 US$ million in 2012-13. During the study period the percentage of growth over the previous year lies between -3.53% and 40.49%. The highest growth rate has been observed (40.49%) in 2010-11 and the lowest growth rate (-3.53%) in the year 2009-10.

Correlation

Correlation analysis was carried out to find out the relationship between the variables (Foreign Direct Investment. and Exports).

Table-2: Correlations

		FDI	Export
FDI	Pearson Correlation	1	.851**
	Sig. (2-tailed)		.002
	N	10	10
Export	Pearson Correlation	.851**	1
	Sig. (2-tailed)	.002	
	N	10	10

**. Correlation is significant at the 0.01 level (2-tailed).

Table 2 exhibits the relationship between the variables (Foreign Direct Investment and Exports). Correlation value is 0.851 which is significant at 0.01 levels. It indicates that as the FDI inflow of the country increases the export also increases.

2. Inflow of Foreign Direct Investment and GDP

Gross Domestic Product (GDP) refers to the market value of all final goods and services produced within a country in a given period of time. It is often considered an indicator of growth and standard of living for a country. Foreign Direct Investment has a close relationship with Gross Domestic Product (GDP) in India. The year-wise FDI inflows along with GDPs secured by India are seen in Table-3.

Table-3: Year-wise Inflow of FDI and GDP (Rs. in Crores)

Years	FDI Inflows	% of Growth	GDP	% of Growth
2003-04	19,879.47	--	2,625,819	--
2004-05	27,544.15	38.56	2,971,464	13.16
2005-06	39,764.44	44.37	3,390,503	14.10
2006-07	103,036.56	159.12	3,953,276	16.60
2007-08	139,856.32	35.73	4,582,086	15.91
2008-09	190,488.65	36.20	5,303,567	15.75
2009-10	179,885.12	-5.57	6,108,903	15.18
2010-11	158,595.67	-11.84	7,266,967	18.96
2011-12	218,915.62	38.03	8,353,495	14.95
2012-13	200,393.08	-8.46	9,461,013	13.26
CAGR	**25.99%**	--	**13.68%**	--

Source: DIPP and Reserve Bank of India, 2013.

Table-3 exhibits the FDI inflows and the Gross Domestic Product (GDP) achieved by the country. The FDI inflows have increased from Rs.19, 879.47 crores in 2003-04 to 2, 00,393.08 crores in 2012-13. The increase over the period was 10.08 times. During the study period, the percentage of growth over the previous year lies between -11.84% and 159.12%. The highest growth rate has been observed (159.12%) in 2006-07 and the lowest growth rate (-11.84%) in the year 2010-11.

The amount of GDP has increased from Rs.26, 25,815 crores in 2003-04 to Rs.9, 461,013 crores in 2012-13. The increase over the period was 3.6 times. During the study period, the percentage of growth over the previous year lies between 13.16% and 18.96%. The highest growth rate has been observed (18.96%) in 2010-11 and the lowest growth rate has been observed (13.16%) in the year 2004-05.

3. Inflow of Foreign Direct Investment and Foreign Exchange Reserves

Foreign Exchange Reserves are assets held by central bank i.e Reserve Bank of India and Monetary authorities. Usually in different reserve currencies, mostly US Dollar, Euro, Pound Sterling and the Japanese Yen. Foreign Exchange Reserves should only include Foreign currency deposits and bonds. However, the term in popular usage commonly also adds Gold reserves, Special Drawing Rights (SDR) and International Monetary Fund (IMF) reserve positions. The FDI inflows along with the foreign exchange reserves of the country are provided in Table-4.

Table-4: Year-wise Inflow of FDI and Foreign Exchange Reserves (Rs. in Crores)

Years	FDI Inflows	% of Growth	Foreign Exchange	% of Growth
2003-04	19,879.47	--	409,129	--
2004-05	27,544.15	38.56	619,116	51.33
2005-06	39,764.44	44.37	676,387	9.25
2006-07	103,036.56	159.12	868,222	28.36
2007-08	139,856.32	35.73	1,237,965	42.59
2008-09	190,488.65	36.20	1,283,865	3.71
2009-10	179,885.12	-5.57	1,259,665	-1.88
2010-11	158,595.67	-11.84	1,361,013	8.05
2011-12	218,915.62	38.03	1,506,139	10.66
2012-13	200,393.08	-8.46	1,588,418	5.46
CAGR	**25.99%**	**--**	**14.53%**	**--**

Source: DIPP and Reserve Bank of India, 2013

Table-4 shows that the FDI inflows and the foreign exchange reserves secured by the country is increasing trend during the study period. The foreign exchange reserves have increased from Rs.4,09,129 crores in 2003-04 to Rs.1,588,418 crores in 2012-13. The increase over the period was 3.88 times. During the study period, the percentage of growth over the previous year lies between -1.88% and 51.33%. The highest growth rate has been observed (51.33%) in 2004-05 and the lowest growth rate (-1.88%) in the year 2009-10.

Correlation

Correlation analysis was carried out to find out the relationship between the variables (Foreign Direct Investment. and Foreign Exchange Reserves).

Table-5: Correlation Analysis

		DI	FER
FDI	Pearson Correlation	1	.969**
	Sig. (2-tailed)		.000
	N	0	10
FER	Pearson Correlation	969**	1
	Sig. (2-tailed)	000	
	N	0	10

**. Correlation is significant at the 0.01 level (2-tailed).

Table 5 exhibits the relationship between the variables (Foreign Direct Investment and Foreign Exchange Reserves). Correlation value is 0.969 which is significant at 0.01 levels. It indicates that as the FDI inflows of the country increases the foreign exchange reserve also increases.

VIII. Findings and Suggestions

Major findings of the study are as follows,

- It is found that the compound annual growth rate of flow of foreign direct investment was 23.90% which is a welcome trend.
- It is found that the compound annual growth rate of export made by the country was 16.76% which is also a welcome trend.
- It is found that the performance with regard to the trend of flow of foreign direct investment was better except the year 2012-13.
- FDI inflow has a positive relationship with exports made by the country.
- It is found that the compound annual growth rate of GDP of the country was 13.68% which is a welcome trend.
- It is found that the trend of GDP was better because of the steady increase in the flow of FDI during the study period.

- The FDI inflow of the country increases which in turn; the amount of foreign exchange reserve is also increased. The increase over the period of the foreign exchange reserve was 3.88 times.
- FDI inflow has a close relationship with the increasing amount of foreign exchange reserve of the country.

There has been a growing presence of Foreign Direct Investment in Indian capital market evidenced by an increase in their net sizable investments. This indicates that Indian capital markets have become vibrant in terms of their composition of various constituents of the market. In India foreign capital helps in increasing the productivity of labour and to build up foreign exchange reserves to meet the current account deficit. Foreign investment provides a channel through which the country can have access to foreign capital. FDIs have significant impact on the Indian economic growth in terms of Export, Gross Domestic Product and Foreign Exchange Reserves. Government should encourage industries to grow to make FDI an attractive avenue to invest.

IX. Conclusion

Foreign Direct Investment (FDI) is a form of long-term international capital movement, made for the purpose of productive activity and accompanied by the intention of managerial control or participation in the management of foreign firm. Foreign investment is necessary not only to supplement domestic capital but also to secure scientific, technical and industrial knowledge. In view of this, the government adopted a liberal attitude by allowing more frequent equity participation to foreign enterprises, and to accept equity capital in technical collaboration in India. In 1998 and 1999, the Government of India announced a number of reforms designed to encourage and promote a favorable business environment for investors. 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 FDI inflows in the country. Thus, foreign investments provide opportunities to host countries to enhance their economic development and opens new vistas opportunities to home countries to optimize their earnings by employing their ideal resources.

The world that looks for very attractive foreign investors. Indian economy is developing very rapidly, it shows unbelievable good indicators and now it has become the fifth largest economy in the world and one of the most developed economies on the continent of Asia. Nowadays in India, foreign investment grows in its volumes and becomes increasingly important.

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