# Foreign direct investment: "policy issues, trends and prospects"

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**Abstract**

Foreign direct investment has boomed in post reform India. India is the fastest-growing free-market democracy. India is the best destination for foreign direct investment and joint ventures in comparison with china. There are more than 100 of the fortune 500 companies' presence in India in compare to only 33 in China. According to survey conducted by FICCI (Federation of Indian Chamber of Commerce) till November 2005, 70% of foreign investors were making profit and another 12% were breaking even. Last year, annual ranking of the world's best small companies, the Forbes 200, included 13 Indian firms but just 4 from China. But the fact is that, India has not attracted anywhere near the amount of FDI that China has. Global investors view china as the world's leading manufacturer and fastest growing consumer market and India as the foremost business process and IT service provider with long term market potential. Foreign direct investment flows to china which total US$60.6 billion till 2004, are primarily capital intensive. In India FDI flows of US$ 5.5 billion are more skill concentrated in information and technology areas. The FDI gap is tale of two Diasporas. China has a large and wealthy Diaspora that has long been eager to help the motherland, and its money has been warmly received. By contrast, the Indian Diaspora is, eager for their own success and much less willing to invest back home. China maintains its position as the most attractive destination in the world. Second position is enjoying by USA. While India is playing real global player rising from sixth position to third position most likely to FDI position globally.

**Keywords:** FDI, Indian Diaspora, China, Capital Intensive.

## Introduction

Foreign Investment is classified in to two categories, foreign direct investment and portfolio investment. Portfolio investment includes fresh inflow of funds from foreign institutional investors (FII) and funds raised by domestic corporates through global depository receipts. Foreign direct investment is investment in distribution, production and other activities of a firm in one country by individuals or businesses from another country.

The main components of FDI are:

1. **Equity Capital** – it involves purchase by the foreign investor, shares of an enterprise in another country.

2. **Reinvested earnings** – it refer to the foreign investor's share of earnings that are not distributed as dividends, but are reinvested into the enterprise in the host country.

3. **Working capital** - it involves short and long term borrowing and lending of funds by the parent investors and their associate enterprises in the host country.

## Motives for Foreign Direct Investment

Three types of motives in a country generally govern foreign investors.

1. **Resource seeking:** Foreign investors investing in another country to take advantage of available production resources like variety of raw materials and natural resources.

2. **Efficiency seeking:** Foreign investors investing in another country to take advantage of low labour costs, skilled labour to improve productivity and efficiency.

3. **Market seeking:** Foreign investors investing in another country to access its markets and to take advantage of their market size and market growth.

## Why Developing Countries Seek FDI?

Developing countries face lack of financial capital resources, technological knowledge and efficient managerial techniques. These resources are important for economic growth and development. FDI is seen as an important source of capital. If channeled properly it can contribute to capital formation in the host country. Developing countries also need FDI to cover their deficits. FDI is also considered an effective mechanism for the distribution of productive information in the global economy. Thus, besides increasing total capital formation, FDI can:

1. Provide access to inputs that are not available locally,
2. Provide access to state-of-the-art technology,
3. Improve management systems, and
4. Expand and diversify production and export capacities.

Developing countries require FDI if they want to incorporate further into the global economy. Countries that have made a conversion from protected economies to open and liberalised economies have considered foreign investment to be important to improve their competitiveness in the international market. This helps them gain access to foreign markets and attain higher export growth. FDI flows are a more stable source of finance as compared to other forms of international private capital flows. Today, FDI is the largest source of private foreign capital reaching developing countries.

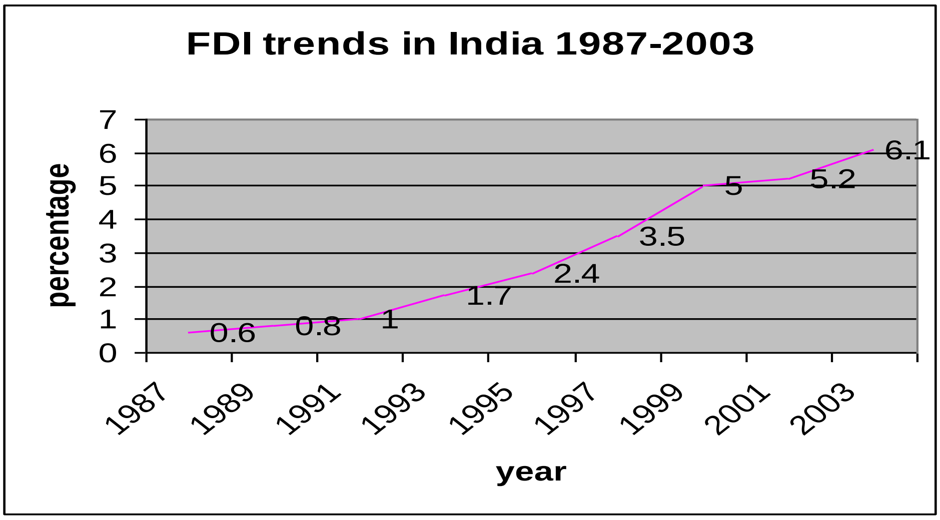
In order to improve per capita income significantly the Government of India has targeted a GDP growth rate of 8.7 percent for the Tenth and Eleventh Plan Periods. As per the estimates this requires a savings-investment rate of 32 percent of GDP. The rate of domestic savings has been in the range of 22-24 percent in the past four years (1998-2002). Despite a projected improvement in the domestic savings rate by 4-5 percent in the next few years, a substantial gap still remains, this creates the need to mobilise foreign investment. India needs FDI to develop its technological capability base. FDI, through transfer of technology, can be a useful instrument to upgrade India's export structure to a more high technology one. If higher export growth is to be realised, India's export structure needs to be made dynamic, with the help of FDI.

**Direction of FDI in India**

There are two types of sectors for foreign direct investment. One which is relatively more labour intensive and low technology and the other is more capital intensive and high technology. FDI policy in India has encouraged FDI in the high technology sector and discouraged FDI in the labour intensive sector. This has been done with the aim of protecting domestic manufacturing industry and to preserve its capabilities in the consumer goods sector and to bring high technology in the electronic and software industry. Today, the top five sectors attracting FDI in India are telecommunications, fuels, electronics and electrical equipment (including computer software), and services sector. There has been a significant change in the direction of FDI into India in the past decade. Engineering, services, electronics and electrical equipment and computers were the main sectors receiving FDI in 2000-01. Sectors such as domestic appliances, finance, food and dairy products, which attracted FDI considerably in the early 1990s, experienced a downtrend in the latter half of the 1990s.

Within the services sector, the software sector has been the focus of FDI policy in India in the 1990s. The inflow of FDI into computers in India increased from 6 percent in 1999-00 to 16 percent in 2000-01. Fuels and telecommunications have been the other two of the largest recipients of FDI. However various policy-induced constraints come in the way of attracting FDI into other prominent export sectors such as textiles & clothing and gems & jewellery. FDI should be encouraged in those sectors where it stimulates further domestic investment and employment. For example, Coca-Cola Company in India is able to generate a huge number of jobs in the downstream areas of bottling and distribution. It is true that Coca-Cola is not an essential need of the people but it is here to stay and people exercise their choice quite wisely when they can satisfy their thirst with other more traditional drinks such as plain water, buttermilk or limewater. There is no evidence to show that consumption of traditional thirst has gone down due to the availability of Coca-Cola in the market.

**FDI trends in India 1987-2003**




**Source**: UNCTAD online database

With a comprehensive view on the foreign direct investments, service industry, energy industry and its relevant sectors remain to be the hotspots of investment growth. At the same time, a lot of inland cities begin to become the targeted areas of foreign investment.

In 2005, the volume of foreign funds attracted to India, which has become the country ranking the second in the world, has surpassed that attracted into the United States. The transition period after the entry into WTO has further cut down the entrance for the Chinese market. The potentials to enjoy the largest growth rate of the service and trade market is a comparative advantage for China to attract foreign investment. It is expected that during a forthcoming period of time, the service industry will remain as a field in the favor of foreign investment in China.

**Sectorial Distribution of FDI Actually Used In India**

Percentage of total

| **Sector/ Industry** | **'92** | **'93** | **'94** | **'95** | **'96** | **'97** | **'98** | **'99** | **'00** | **'01** |
|---|---|---|---|---|---|---|---|---|---|---|
| Chemical & allied products | 17 | 18 | 16 | 9 | 15 | 9 | 19 | 8 | 7 | 2 |
| Engineering | 25 | 8 | 15 | 18 | 35 | 20 | 21 | 21 | 14 | 8 |
| Domestic products | 6 | 1 | 12 | 0 | 1 | 2 | 0 | 0 | 0 | 0 |
| Electronics & Electric items | 12 | 14 | 6 | 9 | 7 | 22 | 11 | 11 | 11 | 22 |
| Food & dairy products | 10 | 11 | 7 | 6 | 12 | 4 | 1 | 8 | 4 | 2 |
| Computers | 3 | 2 | 1 | 4 | 3 | 5 | 5 | 6 | 16 | 12 |
| Pharma. | 1 | 12 | 1 | 4 | 2 | 1 | 1 | 3 | 3 | 2 |
| Others | 24 | 19 | 20 | 24 | 13 | 21 | 15 | 35 | 29 | 13 |
| Finance | 1 | 10 | 11 | 19 | 11 | 5 | 9 | 1 | 2 | 1 |
| Services | 1 | 5 | 11 | 7 | 1 | 11 | 18 | 7 | 12 | 38 |
| Total | 100 | 100 | 100 | 100 | 100 | 100 | 100 | 100 | 100 | 100 |

**Source:** Computed on the basis of RBI annual reports, various issues.

India's reform program of 1991 has boosted FDI inflows. Annual average inflows of US$ 200 million in 1987-1990 against annual average inflows of US$ 4.1 billion in 2001-2004 (UNCTAD online database). FDI inflows accounted for 3.2 percent of gross fixed capital formation in 2001-2004 Compared with China 14.9 percent in 2004. However, in the pre-reform period of 1987-1990, FDI inflows accounted for just 0.3 percent of gross fixed capital formation in India. Inward FDI stocks, relative to GDP, soared from less than one percent in the early 1990s to almost six percent in 2004 while it was 8.2 percent in 2004 for China.

The post-reform period is not only characterized by booming FDI. At the same time, the sector and industry-wise composition of FDI has changed dramatically. Comparable data on inward FDI stocks for specific sectors and industries are available only until 2002. These data reveal a tremendous shift from FDI in the primary and the manufacturing sectors to FDI in services since the mid-1990s. In the manufacturing sector, all previous priority areas, the chemical industry and electrical and non electrical machinery accounted for decreasing shares in overall FDI stocks.

Furthermore, priority areas have changed within the manufacturing sector, too. However, the data situation leaves much to be desired when it comes to FDI in services. This is mainly because booming FDI stocks in the services sector are largely confined to the unspecified category of "other services." Most probably, FDI in this category is heavily concentrated in information and communication services. Telecommunications accounted for about 60 percent of FDI approvals in the services sector during 1991-2000. Recent information on actual FDI inflows shows that services subsumed by the Reserve Bank of India under "computer services" and "financing, insurance, real estate and business services" accounted for 30 percent of total FDI inflows in 2002/03-2004/05.

**India's Progress**

The last decade has witnessed an annual average growth rate of around 6% per annum in India's GDP. As per the Estimates for the first half of 2005-06, GDP grew by 8.1% as against 7.1% in the corresponding period last year. Manufacturing GDP grew by 10.2% in first half of 2005-06 as compared to 8.8% during the corresponding period last year. More importantly, India has been maintaining GDP growth of 6-8% year after year.

Total FDI into India since the liberalization process is US$ 36.28 billion up to November 2005. A FDI inflow in 2004-05 has increased by over 42% from US$ 2.63 billion in 2003-04 to US$ 3.75 billion in 2004-05. During April to November 2005, FDI inflow has been US$ 3.36 billion as compared to US$ 2.25 billion during the corresponding period for the previous year. The FDI inflows have registered an increase of 49% during the period April-November 2005 over the corresponding period of the previous year. The increase in FDI inflows during November 2005 is US$ 775 million compared to November 2004 US$ 301.5 million is 157%.

The year 2004-05 witnessed further industrial recovery. The industrial growth, measured in terms of Index of Industrial Production (IIP), increased from 2.7% in 20001-02 to 5.7% in 2002-03, 7.0% in 2003-04 and 8.4% in 2004-05. The robust industrial growth continues and the IIP has grown by 8.8% during the period April-November2005 over the corresponding period last year.

The FDI Confidence Index 2005' has ranked India as the $2^{nd}$ most attractive investment destination. 'World Investment Report, 2005' has ranked India as $2^{nd}$ most attractive investment destination among Transnational Corporations. India is also the most attractive location for "offshoring "of service activities as per 'A. T. Kearney Global services Location Index, 2005'.

**Future Challenges**

Walk into market and you won't be surprised to see the Chinese-made goods--everything from shoes and garments to toys and electronics. But everywhere "Made in China" label unclear an important point: Few of these products are made by original Chinese companies. In fact, you would be hard-pressed to find a single homegrown Chinese firm that operates on a global scale and markets its own products abroad. That is because China's export-led manufacturing boom is largely a creation of foreign direct investment (FDI), which effectively serves as a substitute for domestic entrepreneurship.

However, the statistics tell only part of the story--the macroeconomic story. At the micro level, things look quite different. There, India displays every bit as much dynamism as China. Indeed, by relying primarily on natural growth, India is making fuller use of its resources and has chosen a path that may well deliver more sustainable progress than China's FDI-driven approach. "Can India overtake China?" is no longer a silly question.

The fact that India is increasingly building from the ground up while China is still stay on a top-down approach reflects their contrasting political systems. In a World Bank study published last year, only 52 percent of the Indian firms surveyed reported problems obtaining capital, versus 80 percent of the Chinese companies. As a result, the Indian firms relied much less on internally generated finances. Only 27 percent of their funding came through operating profits, versus 57 percent for the Chinese firms.

In China, bureaucrats remain the gatekeepers, tightly controlling capital allocation and severely restricting the ability of private companies to obtain stock market listings and access the money they need to grow. Indeed, Beijing has used the financial markets mainly as a way of keeping the SOEs (state owned enterprises) afloat. These policies have produced enormous distortions while preventing China's markets from gaining depth and maturity. It is widely claimed that China's stock markets have a total capitalization in excess of $400 billion, but factoring out non-tradeable shares owned by the government or by government-owned companies reduces the valuation to just around $150 billion.

Until now, the Indian Diaspora has accounted for less than 10 percent of the foreign money flowing to India. With the welcome mat now laid out, direct investment from nonresident Indians is likely to increase. And while the Indian Diaspora may not be able to match the Chinese Diaspora, Indians abroad have substantially more intellectual capital to contribute, which could prove even more valuable.

India has pursued radically different development strategies. India is not outperforming China overall, but it is doing better in certain key areas. That success may enable it to catch up with and perhaps even overtake China. Should that prove to be the case, it will not only demonstrate the importance of homegrown entrepreneurship to long-term economic development; it will also show the limits of the FDI-dependent approach China is pursuing.

**Conclusion**

If India has so clearly surpassed China at the grassroots level, why isn't India's superiority reflected in the numbers? Why is the gap in GDP and other benchmarks still so wide? It is worth recalling that India's economic reforms only began in earnest in 1991, more than a decade after China began liberalizing. In addition to the late start, India has had to make do with a national savings rate half that of China's and 90% less FDI. Moreover, India is an extensive, disorganized democracy driven by ethnic and religious tensions, and it has also had a longstanding, volatile dispute with India over Kashmir. China, on the other hand has enjoyed two decades of relative silence apart from Tiananmen Square, it has been able to focus almost exclusively on economic development.

It is the fact that India still has a long way to go to catch up with China. In 2004, India attracted a fraction of China's FDI - approximately $5 billion - against China's $60 billion. This has been partially fueled by China's overseas community investing significantly more in China than Non-Resident Indians (NRIs) did in India. India still requires a number of structural reforms, including addressing issues of corruption, "license raj", and infrastructure improvements to its electricity generation and transmission, road, rail and air networks.

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