DETERMINANTS OF FOREIGN DIRECT INVESTMENT (FDI) IN INDIA

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Abstract

With the advent of globalization, developing countries have been witnessing a massive surge in foreign direct investment (FDI) inflows over the past two decades. It is a key determinant of economic development in many countries including India. FDI provides opportunities to Indian industries through technological, managerial and resource improvements. Foreign Direct Investment (FDI) as a powerful vehicle for the economy plays a crucial role in integrating the domestic economy with the rest of the world. However, FDI in India has increased over the years owing to the efforts made by the Indian government. The non-stop increase in foreign direct investment (FDI), strengthens the confidence of the corporate sector for investment in the global economy. Foreign investors perceive India as a market for their trades. The main purpose of this research is to discuss the determinants of foreign direct investment (FDI) in India and attract foreign investors here.

Keywords: Foreign Direct Investment (FDI), India, Market, Determinants, Investor, Market, Sector, Country.

Introduction

In the globalized economy of any nation, FDI's role is very important because it accelerates the pace of development and the opportunities for employment which can bridge that investment savings gap and achieve sustained growth. FDI is a vehicle for bringing foreign technology, knowledge, managerial skills and other essential inputs to participate and compete in international marketing, distribution and production networks in competition between firms and the economic performance of the countries they serve. Flows from FDI are generally preferred because they are non-debt-creating and non-volatile. In a world of increased competition and rapid technological changes their complementary and catalytic roles can be very valuable. FDI is very conducive to economic development and capacity building for our country. The last two decades have seen rapid transformations in the international economic and political environment. Due to the liberalization of economic policies, foreign direct investment (FDI) have grown as there is an increasing interest in emergent and developing economies around the world. India linked international markets by

restructuring the country's economic policies and opening up the country to global trade and investment. Many countries are actively working to attract more FDI by increasing revenue generation and resource inflow, innovative technology and market management.

The New Economic Policy initiated in India in July 1991 provided a major stimulus to foreign direct investment in India that provided inter alia automatic approval for projects with foreign equity participation of up to 51% in high-priority areas of the Indian economy. A series of measures followed these liberalization measures in later years, further liberalizing the inward-looking policy regime of FDI. A new foreign investment policy was put in place that stipulated three tiers for approving proposals for FDI: (i) the Reserve Bank of India's automatic approval system (ii) the Secretariat for Industrial Approvals (SIA) for proposals falling outside the powers delegated to the RBI and (iii) the Foreign Investment Promotion Board (FIPB), specially created to invite, negotiate and facilitate substantial foreign investment. Since then, the Government of India has taken several measures including the enhancement of foreign equity participation through the automatic route, the reduction of the negative list, the provision of incentives and the opening up of more sectors for FDI's entry into the Indian economy.

India's economic reforms back in 1991 have generated strong interest from foreign investors and turned India into one of the favourite destinations for global FDI flows. According to A. T. Kearney, India ranks second in the world in terms of attractiveness for FDI. A. T. Kearney’s 2007 Global Services Locations Index ranks India as the most preferred destination in terms of financial attractiveness, people and skills availability and business environment. Similarly, UNCTAD's 2005 World Investment Report considers India the 2nd most attractive destination among the TNCS. The positive perception among investors is that strong economic fundamentals driven by economic reforms have helped FDI inflows grow significantly in India.

India has been one of the most developed countries in the world and has managed to show positive GDP growth even while in recession. It has performed comparatively well, even when compared to the average growth rate of world GDP. According to UNCTAD in its World Investment Report 2010, “If the situation continues to improve, India is likely to be among the most promising investor-home countries in 2010-12 as well as the third highest economy for FDI in 2010-12". India has all the variables including fine infrastructure, potential markets, abundant labour, the availability of natural resources and finally the economic and trade policies that have been favouring FDI.

The International Monetary Fund (1977) defines FDI as an “investment that is made to acquire a lasting interest in an enterprise operating in an economy other than that of the investor. The investor’s purpose being to have an effective voice in the management of the enterprise".

Determinants of Foreign Direct Investment

The case for attracting large volumes of FDI into India requires an analysis of the determinants of FDI in the Indian context. Some important determinants influencing the FDI inflow into India are as follows:

Market size

Generally, market size is measured by gross domestic product (GDP), per capita income and the size of the middle-class population of the economy. It is estimated to be a positive and substantial determinant of FDI flows as it provides opportunities for big sales, thereby covering more profits. The higher the Gross Domestic Product (GDP), the better the country’s economic well-being and so are the predictions that direct investment will be beneficial. The size of the market is a sign of the depth and breadth of the domestic economy. The market size of the host country is a key determinant of FDI. In a logical theoretical construct, market size positively influences FDI inflow to a particular location. Higher market size indicates higher potential demand, higher purchasing power and lower costs as well as economies of scale where firms can potentially receive higher returns on investment and obtain higher profits from their investments.

The huge size of the Indian market is considered one of the most important factors attracting FDI in India. To benefit from the size of the economy of the host country and to cut down on production costs, all international partners will need to produce on a large scale. In comparison to other countries in Asia, India is very attractive and in a very beneficial position. In this context, it is relevant to state that India has been one of the fastest-growing countries in the world. In comparison to other countries in Asia, India is very attractive and in a very beneficial position. The U. S. Commerce Department calls India one of the 10 emerging markets in the world which means that the biggest growth in investment will come from the big emerging markets and developed countries. Similarly, the World Bank has categorized India as the fifth-largest economy in the world after the USA, China, Japan and Germany.

Trade Openness

The 'openness' of the host country is an important determinant of FDI as it allows for easier importing of raw materials and capital goods which are necessary for investment. This is an

index for evaluating the strength of international economic relations. The growing value of foreign trade is a good sign for an economy that is expanding internationally. Openness to the economy can be realized by limiting FDI and trade barriers. Openness in the economy manages export-led growth through regular FDI inflows. In general, it is expected to be a significant and positive determinant of FDI. Liberal policies regarding foreign ownership, profit returns and difficult-to-manage financial stability may be attracting more foreign capital.

Ever since the introduction of economic restructuring policies in the early 1990s, India has been opening up its economy progressively with a view to creating an interminable foreign investment climate in the country. As a result, India's trade as a percentage of GDP has increased dramatically since the trade reforms took place in 1991. The government formulated a liberalized trade policy with the intention of attracting more and more FDI inflows. Studies are abundant that acknowledge economic openness as a positive and significant determinant of FDI. Trade openness is the ratio of the sum of the exports and imports of a country to its GDP.

Foreign Exchange Reserves

Financial position refers to the foreign exchange position of the host country which also acts as a determining factor for FDI. A high stock of foreign exchange reserves is a good sign of a nation's claim to control foreign economies. The higher level of foreign exchange reserves in terms of import cover shows the strength of the country's external payments position and helps to increase the confidence of foreign investors. Higher foreign exchange reserves improve the financial status of a country and can lead to higher FDI inflows. Therefore, a positive relationship is expected between the foreign exchange reserves and the inflow of foreign direct investment which is expected to increase in the coming years. It would build confidence in the minds of investors that the return of their profits to their home countries would not discourage them. Furthermore, increasing a country's foreign exchange reserves increases a country's potential to pay for imports, external debts and other external accountability for its own financial failures. Thus, a growing foreign exchange reserve indicates improved financial health for a country. As far as the Indian economy is concerned, there was a stumbling block during the early 1990's when the financial crisis made India unable to pay for imports. The problem of poor balance of payments (BOP) in India was basically due to a huge trade deficit. But with the reforms, India has managed to increase its foreign exchange reserves to the desired level. India's foreign exchange reserves in dollar terms have increased by nearly 60 times from 2236 million U. S. dollars in March 1991 to

135571 million U. S. dollars in March 2005. It shows her strength in her external payment position. This means that a higher level of foreign exchange reserves leads to an inflow of more FDI into the country.

Tax Rate

Fiscal policies control average tax rates (including corporate and personal tax rates) and thereby win over inflows of FDI. Other things being equal, a country with lower tax rates should stand a better chance of attracting an FDI project than a country with higher rates. Any change in tax rates on corporate income, such as dividends, royalties, technical fees and capital gains received by a foreign company is likely to affect the inward flow of FDI. Corporate tax rates directly have an effect on the returns of foreign investment and thus the decisions of investors when starting FDI. Countries wanting to attract more FDI, therefore may have to be concerned about lowering their corporate tax rates to become more economical with other countries. Lower rates of corporate taxes will therefore offer fiscal incentives that will cut down on the financial costs of foreign companies and maximize the locational advantages. Despite this, a satisfactory measure of corporate taxes has proven problematic. When compared to other Asian countries, corporate tax rates in India are quite high. Thus, the Indian Corporation's tax structure needs to be altered appropriately in order to make it more definite and transparent and a difference should be drawn between the nominal tax rates and effective tax rates.

Cost of Capital

The cost of capital is a very important factor to be considered when making an investment in a project. Foreign firms often try to bring down costs in order to maintain price competitiveness. Thus, the availability of capital at the current lending rates may permit foreign direct investors not only to locate a better partner in the host country with sufficient domestic investment to increase but also to maximize the return on their investment. This would mean that the easy availability of capital at cheaper rates in the host country would exert a pull on direct investors from outside the country which would then be able to attract foreign investors. However, the impact of the cost of capital on FDI inflows has been found to be uncertain in nature. It can be claimed that higher lending rates may have a positive impact on FDI inflows in that the cost of capital in the host country is higher and that foreign firms bring in more capital. In contrast, it can also be argued that the host country's cost of capital depends directly on its impact on domestic consumption. As such, the lower the cost of capital in the host country, the higher the domestic consumption and hence, the higher the FDI inflow. Additionally, it is largely assumed that when the cost of capital increases, the

economy will be adversely affected as it impinges on capital formation. The corporate sector is highly sensitive to higher interest rates because they increase financial costs. When foreign investors invest in a country with lower interest rates, they are able to finance their projects locally and cut down on both capital costs and foreign exchange risk. Rates of interest charged in India for financing a project are very high compared to other nations. This high rate of interest is one constraint being put on the inflow of capital into India.

Cost of Labour

Cheap and productive labour ensures a reduction in the cost of production and yields higher returns to the investor. To make FDI profitable, there must be conditions in the host country that make production attractive to the investor. Production by multinationals in the host country is expected to be more profitable than that exported to that country. The wage differential is one factor that ensures profit by creating a low-cost environment to attract multinational investment in the host country. Instead of producing and exporting products from their home countries, they attract investors by producing in the host country.

However, when the cost of labour is not of the utmost importance, the productivity and skills of the labour force are expected to have an impact on decisions about whether FDI is a viable solution. Foreign direct investment does flow to countries where there is a greater availability of comparatively cheap labour than in the home countries. The availability of educated and skilled labour at a low cost is a factor as to why many foreign investors decided to enter the Indian market to conduct their business which has a positive impact on FDI inflow in India. Results in developing countries like India reveal that relatively lower wage rates i.e. low labour costs are a significant determinant of FDI inflows in the country.

Exchange Rate

The rate of a currency with respect to international currencies is an influential determinant of capital movements across borders. It is also a crucial indicator of international economic transactions. Ever since the fall of the gold standard, the internal economic character of an economy has played an essential role in determining the exchange rate. Exchange rates are important for FDI because FDI can be considered an alternative to exports. The exchange rate of a currency reveals the international competitiveness of its economy. Any appreciation or depreciation indicates a deterioration or enhancement in the country's international competitiveness. Many of India's trade competitors have made large exchange rate adjustments over the past few years. For instance, China and Indonesia depreciated their currencies against the US dollar more than India did, in spite of their lower rates of inflation. The effects of the exchange rate on FDI may run through two channels. First, it manages the

foreign investor's gains and losses. The net effect is uncertain and the results are mixed. Second, a depreciation that is expected to be way up will support FDI inflows to capital gains when the domestic currency appreciates. The depreciation of currency value makes production cheaper and exports simpler. Hence, there is a need to attract resource-seeking and efficiency-seeking FDI. However, a constant fall in production costs after entering the host country would raise production costs and discourage FDI. There may, however be an enduring role with respect to exchange rates, for example, in determining the value of repatriated profits or in the threatened limitations of such payments. Therefore, devalued exchange rates are expected to encourage FDI to flow into host countries like India.

Availability of Infrastructure

Infrastructure is an important determinant of the competitiveness of an economy. It is essential for confirming the real functioning of the economy, as it is a key factor determining the location of economic activity as well as the types of activities or sectors that can develop in a particular country. Well-developed, extensive and high-quality infrastructure not only helps in integrating markets into the economy but also significantly impacts economic growth. Efficiency-seeking FDI would flow only to those countries where better infrastructure is available. Higher the availability of infrastructure, lowers the infrastructure cost and increases the ability of the host country to attract FDI. In the present context of the globalized economy, the flow of goods and capital across the world largely depends on the availability of communications and transportation infrastructure. Additionally, the availability of power, particularly electricity also plays a key role in investment decision-making. Good infrastructure fuels the efficiency of investments and therefore speeds up FDI inflows. To gear up the inflow of FDI, host countries must ensure not only the availability of such infrastructure but also the reliability of such infrastructure. A lack of developed infrastructure is another chunk in the inflow of foreign direct investment into India. Much of the difficulty can be observed in other areas, such as roads, railways, ports, power, telecommunications, water supply and sewerage systems. India's inability to implement infrastructure projects such as electricity, roads and railways is further worsening the situation. If infrastructural constraints are not dislodged in a timely manner, India will not be able to grow as an industrialized country. These infrastructural problems are putting hindrances in the path of progress for India.

Capital Market Strength

Capital markets are responsible for mobilizing and allocating capital, pricing and apportioning risk. Their task is to ensure that capital flows to its most optimal use and is

allocated for economic rather than political reasons. Developing countries to attract FDI must enforce a capital allocation system with strict and transparent rules and regulations. Foreign investors who want to engage in joint ventures with domestic investors will analyze the strength of capital markets in the host country and ensure the easy and continuous availability of capital for their venture. Reforms in the Indian capital market made it comparable to many developed markets in terms of qualitative as well as quantitative parameters. The market has witnessed fundamental, institutional changes resulting in drastic reductions in transaction costs and significant improvements in efficiency, transparency and safety. At the end of 2001, Standard & Poor's (S&P) ranked the Indian stock market 25th in terms of market capitalization, 15th in terms of total value traded and 6th in terms of turnover ratio.

Debt - GDP Ratio

High levels of external debt increase the burden of repayment and debt servicing on the economy. It further determines the financial strength of a host country's economy. Increasing debt liabilities would deteriorate the financial health of a country, ultimately causing instability in the economy. Any such situation would certainly deter foreign direct investment from entering the country. Debt liabilities have to be managed in such a way as not to exceed the potential for repayment. Lower the external debt to GDP ratio and higher is the probability of economic stability and the inflow of FDI. The level of indebtedness exhibits the burden of repayment and debt servicing on the economy and makes the country less attractive for foreign investors. Hence, a lower external debt-to-GDP ratio attracts higher FDI inflows.

In 1990-91, India's external debt was estimated at 83.80 billion U. S. dollars and the debt-to-GDP ratio was 38.7 percent while debt servicing as a percentage of current receipts stood at 35.3 percent. This was a critical situation that was nearing the end of the "debt trap". However, consistent reforms made it possible to recover from such situations and the debt-to-GDP ratio began to fall from 38.7 percent in 1990-91 to 17.6 percent in 2003-04 in spite of increases in absolute value. Debt service ratios have also declined from 35.3 percent in 1990-91 to 14.1 percent in 2001-a02 due to the sharp fall in the rate of interest in the world market. India is expected to attract more FDI with a declining debt-to-GDP ratio.

Industrial Disputes

Industrial disputes hamper the production process and create instability in an economy. A feasible industrial relationship ensuring continuous production without any deterring factors is required to attract FDI inflow. Any industrial dispute over labour costs and work stoppages is a serious problem. Hence, industrial disputes are a potential constraint for foreign direct

investment. Foreign investors would prefer to invest in those countries where there is continuous availability of productive labour and a smaller number of strikes. Monthly losses due to industrial disputes are a proxy widely used in previous studies on FDI. These are directly related to FDI inflows because disrupted production could increase production costs. Foreign investors prefer to invest in countries where there is continuous availability of productive labour and fewer strikes.

Natural Resources

Historically, the availability of natural resources has been identified as one of the most significant determinants of FDI. The abundance of natural resources (e.g., mineral deposits, raw materials and agricultural products) has been assumed to be a key factor in attracting FDI in primary sector activities by offering the opportunity for vertical integration in host locations. Natural resources play a vital role in overall FDI attrition and decision-making. FDI tends to flow into countries that are rich in resources but lack the capital, technical skills and infrastructure required for the exploitation of natural resources available in the country and India is one of those countries.

GATT Round:

The 1994 round of GATT in Uruguay was an important step towards affecting the flow of FDI in India. It was a positive step and was in favour of international direct investment. The WTO advocated the removal of all forms of restrictions on imports and favoured a free flow of goods and capital among member countries. This determinant has also been a major factor in attracting more FDI in India.

Government Policies

The concessions and privileges provided to countries that invest and the favourable policies of the host country promote FDI. Policies towards foreign investment, foreign collaboration, foreign exchange control, remittances and incentives—both monetary and fiscal—offered to foreign investors exercise a significant influence on FDI in a country. In India, Export Processing Zones (EPZs) have been developed as a favourable environment for FDI. The Government of India is also making sincere efforts to attract and promote foreign direct investment in order to supplement domestic capital, technology and skills needed for accelerated economic growth.

Conclusion

During the liberalization period, India has attracted a quantum amount of foreign direct investment, especially after the liberalization of the Indian economy. As a result, FDI enabled India to achieve a certain degree of financial stability, growth and development to sustain and

compete in the global economy. The increased flow of FDI in India has given key support to the country's economy and so measures must be taken in order to make sure that the flow of FDI in India continues to grow. In the present era of globalization, liberalization and privatization (LPG), the role of foreign direct investment cannot be ignored. An important task for policymakers is to identify the factors that attract more FDI to the economy. Concisely, despite trouble in the world economy, India has continued to attract substantial amounts of FDI inflows. India due to its flexible investment regimes and policies has proven to be a horde for foreign investors looking for investment opportunities in the country.

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