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Foreign Direct Investment in India: Some Emerging Trends

Pradeep Kumar Keshari[1]

1. Introduction

Foreign direct investment (hereafter FDI) is a venture undertaken to acquire a lasting interest and an effective voice in the management of a foreign enterprise (IMF 1977). FDI can perceivably benefit the developing economies in several ways including, for instance, by: i) adding to their scare financial resources for domestic investments; (ii) augmenting their foreign exchange earnings by increasing exports with the help of the worldwide network of the multinational corporations (MNCs) – the vehicles of FDI; (iii) bringing in advanced technology and improved managerial skills which are scarcely available in these countries; (iv) improving competition and overall efficiency in the domestic economy through the entry of new foreign firms or more investment in the existing firms and considerably reducing the scope for 'rent-seeking' by the protected local firms and (v) creating additional employment opportunities for their human as well as material resources.

With a view to maximizing the above mentioned benefits, Government of India (GoI) followed a very selective policy towards the inflow of FDI and foreign collaborations till the late seventies. A highly complex regulatory framework, including Foreign Exchange Regulation Act (FERA), was evolved and promulgated in 1973 for governing financial and technical collaboration agreements between Indian and foreign companies. This regulatory framework imposes severe restrictions on almost every aspect of foreign collaborations, for instance on the entry of a foreign firm, degree of foreign equity participation, repatriation of profits and dividends, the amount of technical fees or royalty payment to be made to foreign collaborators, the duration of technical collaboration agreements and the sectors in which the foreign collaborations are to be permitted. Among these restrictions, the one limiting foreign equity participation only upto 40 per cent was viewed among potential foreign investors as a most inhibiting factor for undertaking any fresh investment in the Indian industries (Martinussen 1988). As a result, a little amount of new foreign investment found its way into India in the seventies (Mukherjee 1987).

A major change in the environment for inward FDI in the Indian industries has taken place since 1980. Although the FERA continues to prevail broadly even today, numerous legislative restrictions have been relaxed, recently several procedures have been streamlined, the ceilings for foreign equity participation in a few sectors have been raised and even the inward FDI unaccompanied by technological know-how from certain quarters has been permitted by the GoI. Major objective of this paper is to examine some of the underlying reasons for the liberal stance of the GoI of India towards the inflow of FDI during the eighties. Section II of the paper briefly summarises the major changes at the policy front in the eighties. The trends and patterns of FDI in India are analyzed in Section III. The Section IV explains the reasons for changes in the GoI's attitude towards FDI and foreign collaborations in general. The final section sums up the study and makes concluding remarks.

II. Development in the Eighties

Towards the end of the seventies, there was a noteworthy change in India's overall economic policy. Liberal industrial and trade policies were adopted with the objectives of

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increasing exports and encouraging competition in hitherto much protected domestic market. A major break in FDI policy occurred in 1980 when GoI allowed investment upto 40 per cent in the equity of new ventures in specified industries from Oil Exporting Developing (OED) countries, without insisting that a technology transfer also should accompany FDI. It should be noted that India always looked upon FDI primarily as a means for the transfer of technology to its manufacturers and it, therefore, used to discourage FDI which was not accompanied by technological know-how.

A second break from the general policy was also allowed in the case of investment by non-resident Indians (NRIs) even if no technology transfer was involved therein. Several schemes were introduced with relaxations under FERA for attracting the funds from NRIs. Some of the cases of relaxations allowed in the procedures and the schemes in which NRIs could invest were: Bulk Investments Scheme for the Revival of Sick Industrial Units, Investment in New Issues of Indian Shipping Companies under 40 per cent scheme Investment in Priority Industries under 40/74 per cent scheme, Removal of Ceilings for Private Limited Companies, Opening of Foreign Collection Accounts, Grant of Rupee Loans/Overdrafts for FDI in Export Oriented Activities, Hospitals, Hotels with 3,4, 5 Star Ratings, Shipping Companies, Development of Computer Software, Oil Exploration, Services and Investment in Country Funds.

The third exception was the investment in export-oriented manufacturing units and service sectors like tourism and travel. It was decided by the GoI to set up four more export processing zones (EPZs), in addition to two existing ones, to attract MNEs. Even 100 per cent foreign equity could be allowed in totally export-oriented units, free trade zones (FTZs) or EPZs. The earlier limit of 40 per cent on foreign equity in tourism related project has been raised to 51 per cent. The period of approval for foreign investment proposals were also increased from one year to two years.

In order to encourage a larger inflow of FDI, GoI set up a committee known as the Fast Tract Arrangement in May 1988. This arrangement has been made for speedy clearance of applications received for various investment proposals in the different Ministries, Government Departments, RBI, etc. Initially this facility was available only to the investors from West Germany and Japan. Subsequently, it was also been extended to those from the UK, the USA and France. The arrangement functions through a special Investment Promotion Group, comprising representatives from Ministries of Finance, Industries and External Affairs under the Chairmanship of Joint Secretary, Investments. The Group looks into any undue delay at any stage of clearance of the FDI proposals. These cover areas like customs clearances, release of foreign exchange for remittances abroad, tax concessions, visa, opening of offices, appointment of personnel, expediting approvals for industrial licensing, investment/collaboration, etc.

As a result of these liberalisation measures and streamlining of procedures, the foreign investment climate in India since 1980 has improved considerably. According to New Industrial Policy announced on May 31, 1990 upto 40 per cent of foreign equity participation in a company will be allowed on an automatic basis provided the landed value of imported capital gods does not exceed 30 per cent of the value of plant and machinery. However, this liberalisation will be applicable only to a "positive list" of industries.

The rules and procedures relating to technological collaborations were also relaxed and streamlined considerably in the eighties. Tax rate on royalties was reduced to

40 per cent in the budget announced in 1986. A special facility for import of design, drawing and related technological input upto a limit of Rs.25 lakh was introduced, which could be availed by all scheduled industries. The procedures for engagement of foreign technical experts/technicians by Indian firms have been liberalized and made easy by giving the RBI more powers since August 1988. Under the new industrial policy, import of technology would be allowed without obtaining clearance from the GoI provided that the royalty payment does not exceed 5 per cent on domestic sales and 8 per cent on exports. If a lump sum payment for technical fee is involved in the import of technology, the proposal for the same would require GoI's clearance with the decision to be communicated to the entrepreneur within a period of 30 days.

III. Trends and Patterns of FDI and Foreign Collaborations in India

The inflow of FDI: a closer scrutiny of the data presented in Table 1 reveals the following: (i) net inflow of FDI from the member countries of Development Assistant Committee (DAC) declined steeply in the three-year period after 1975 becoming negative during 1977 as $ 36 million were transferred from India to these developed countries. This decline and perverse flow was attributed largely to the provisions of FERA as it seemed to project among potential foreign investors India's unwelcoming attitude towards FDI (Martinussen 1988); (ii) by 1979, however, FDI flows from DAC regained their earlier level ($ 49 million) as before the enforcement of FERA and reached a peak of $ 93 million in 1981; (iii) The flow of FDI in India began to decline afterwards and reached a very low level of $ 6 million in 1983. This decline has occurred in spite of the GoI's liberal attitude towards FDI and improved economic situation since 1980 in the country. This phenomenon, therefore, can be attributed to the general downward trend observed in the net inflow of FDI to the developing countries in the beginning of the decade (According to the OECD sources, net inflow of FDI from DAC to developing countries declined substantially from a high of $ 17 billion in 1981 to $ 9.3 billion in 1983); (iv) Since 1984, however, the inflow of FDI suddenly scaled new heights : First, it rose sharply to $ 19.2 million in 1984 from its very low level in 1983 and then reached another new high of $ 105.1 million in 1985. In 1987, the latest year for which the data is available, it shot up to an all time high of $ 142 million. The above increases were, perhaps, the result of the GoI's persistent efforts for attracting a larger inflow of FDI.

Table 1: Net inflow of FDI into India

(US dollar million)

Year	1975	1977	1979	1980	1981	1982	1983	1984	1985	1986	1987
Net FDI from DAC	87	-36	49	79	92	72	6.0	19	106	117	142

Source: OECD, Geographical Distribution of Financial Flows to Developing Countries, 1989 and various earlier issues

In comparison to Newly Industrializing Countries (NICs) or South-East Asian developing countries, however, the FDI in India is low indeed. For instance, cumulative

flow of FDI in India during 1977-85 stood at $ 268.5 million which compares miserably with the figures of $ 3785.9 million for Hong Kong, $ 3770.8 million for Singapore, $3796.5 million for Indonesia and $ 1127.5 million for Thailand (see Table 2). In a more revealing way Table 3 shows that the percentages of net FDI in total inflow of resources and gross domestic capital formation in India on cumulative basis during 1988-85 were as low as 1.6 and 0.1 respectively. On the contrary, the NICs and South-East Asian countries had shown much higher percentages. The Indian figure compared favourably only with that of South Asia. In the latter countries the net inflow of FDI as a percentage of their total resource flow and gross domestic capital formation were 1.1 and 0.1 respectively during 1977-85. The reason for such a low level of flow in comparison to South-East Asian and NICs lies mainly in India's restrictive policies towards FDI in 1970s and the downturn experienced in the beginning of the eighties. Nevertheless, there are some encouraging trends visible since the mid-eighties. During 1985-87 the cumulative flow of FDI in India as a proportion of its total resource flow and GDCF has gone up to 3.76 and 0.25 percent respectively. This may be the outcome of the further liberalization measures undertaken by the GoI since 1985 onwards.

Table 2: Net FDI and its relative proportions

Name of Country	Net FDI ($ million)		Net FDI as percentage of		
			Total resource flow		Gross domestic capital formation (GDCF)
	1977-85	1985-87	1977-85	1985-87	1977-85
NICs	9148.2		35.4		2.3
Hong Kong	3785.9		61.8		5.4
Korea, Rep.of	723.9		5.5		0.4
Singapore	3770.8		73.4		7.0
Taipei, China	867.6		62.0		0.9
Southeast Asia	6241.3		13.7		1.7
Indonesia	3796.5		18.8		2.7
Malaysia	688.2		10.0		1.0
Philippines	629.1		6.9		0.8
Thailand	1127.5		12.0		1.4
South Asia	488.1		1.1		0.1
Afghanistan	10.5		2.5		-
Bangladesh	23.8		0.2		0.2
Burma	1.0		0.0		0.0
India	268.5	365.4	1.6	3.76	0.1
Nepal	1.9		0.1		0.1
Pakisthan	60.4		0.8		0.2
Sri Lanka	122.0		3.1		1.2

Sources: 1. ADB, Key Indicators of Developing Member Countries of ADB, Manila, July 1987, 1990
2. OECD, Geographical Distribution of Financial Flows to Developing Countries, Paris, 1989.
3. Rana, P. B, "Foreign Direct Investment and Economic Growth in the Asian and Pacific Region, "Asian Development Review, Vol. 5, No.1, 1987.

Magnitude and Sectoral Composition: The data presented in Table 3 exhibit the rupee value of the total stock of FDI and its percentage distribution across industries in

different years during 1948 to 1980. The stock of FDI which stood at Rs.255.9 crore in 1948 registered an upward trend in the following period up to 1980. It went up to Rs.528.4 cr. in 1961 to Rs.920.2 cr. in 1977 and to Rs.933.2 cr. in 1961 to Rs.920.2 cr. in 1977 and to Rs.933 cr. in 1980. Sectorally in 1948, a major portion (72.2 per cent) of the total FDI was concentrated in Plantation, Mining and Petroleum (33.6 per cent) and in Services (38.6 per cent). The manufacturing sector accounted for only 27.8 per cent of the total FDI in India. Since then the share of manufacturing sector rose to 35.3 per cent in 1961, 53.1 per cent in 1969, 80.6 per cent in 1977 and 87.0 per cent in 1980. Within the manufacturing sector the FDI got more oriented towards relatively technology intensive industries such as machinery and machine tools, electrical goods, and chemicals and allied products. These improvements in the shares of technology intensive industries have taken place at the cost of technologically less advanced industries like food and beverages, textile products, etc. These significant changes in the sectoral composition of FDI were brought about by a very selective policy of the GoI, which aimed at diverting FDI to capital goods industries that employ advanced technology for production or to export oriented manufactures. Moreover, nationalisation of selective non-manufacturing industries also helped to reduce the shares of FDI in these industries.

Table 3: Sectoral distribution of the stock of FDI in India, 1948-80

(Rs.crore)

Industry group	March 1948		March 1961		March 1969		March 1977		March 1980	
	Value	%	Value	%	Value	%	Value	%	Value	%
1. Plantations	52.3	20.4	100.5	19.0	122.5	16.7	74.8	8.1	38.5	4.1
2. Mining	11.5	4.5	10.9	2.1	3.7	0.5	7.7	0.8	7.8	0.8
3.Petroleum	22.3	8.7	148.1	28.0	131.5	17.8	50.7	5.5	36.8	3.9
4 Manufacturing	71.0	27.8	186.8	35.3	392.0	53.1	742.0	80.6	811.6	87
a) Food and beverages	10.1	14.2	33.7	18.0	40.5	10.3	45.5	6.1	39.1	4.8
(b) Textile products	28.0	39.4	14.0	7.5	17.7	4.5	31.2	3.2	32.0	3.9
(c) Transport equipment	1.0	1.4	8.6	4.6	25.7	6.6	41.8	5.6	51.5	6.3
(d) Machinery and machine tools	1.2	1.7	7.9	4.3	25.0	6.4	59.6	8.0	71.0	8.8
(e) Metals and metal products	8.0	11.3	26.7	14.3	61.2	15.6	10.10	13.6	118.7	14.6
(f) Electrical machinery	4.8	6.8	12.0	6.4	41.3	10.5	83.8	11.3	97.5	12
(g) Chemicals and allied products	8.0	11.3	47.6	25.5	115.8	29.5	264.1	35.6	301.8	37.2
(h) Other	9.9	6.8	36.3	19.4	64.8	16.5	115.0	15.5.	100.0	12.3
5. Services	98.8	38.6	82.1	15.6	88.0	12.0	45.0	4.9	38.5	4.1
Total	256	100	528	100	738	100	920	100	933	100

Source: Reserve Bank of India Bulletin (Various Issues)

Country wise distribution of foreign collaboration approvals and FDI amounts: As can be seen from Table 4, total number of foreign collaboration approvals from all the source countries was 2698 during the seventies. This increased almost two and half times to 6688 during the first nine-years of the eighties. Accordingly, the average number of

approvals increased sharply from 270 per year over the period 1970-79 to 743 over 1980-88. The increase in the average number of financial collaborations has been even more pronounced. It went up from 39 per year during 1970-79 to about 169 per year during 1980-88, raising their share in total approvals from 14.4 per cent to 22.7 per cent.

During 1970-79, the USA had the highest share (20.4 per cent) followed by the Federal Republic of Germany (FRG) (20.1 per cent), the UK (19.8 per cent), Japan (8.7 per cent), Switzerland (7.0 per cent), France (5.7 per cent) and Italy (3.6 per cent). The period 1980-88 did not witness any change in the sequence of the shares of the US, the FRG, the UK and Japan, but those of Switzerland, France and Italy got even reversed with Italy occupying fifth position (5.4 per cent), followed by France (5.1 per cent) and Switzerland (4.9 per cent). During the same period the share of the USA (20.5 per cent) remained almost in tact and the share of Japan (9.4 per cent) increased but there was a fall in the shares of FRG (18.5 per cent) and the UK (16.1 per cent). The share of "other countries" in the number of total foreign collaborations also went up to 20 per cent during 1980-88 from 14.6 per cent during 1970-79. It is mainly attributable to the shift in our dependence for FDI from the major investors mentioned above.

Table 4 : Source country wise distribution of number of foreign collaborations approvals

Period	USA	FRG	UK	Japan	Switzerland	France	Italy	Others	Total
1970-79	550 (20.4)	543 (20.1)	535 (19.8)	236 (8.7)	189 (7.0)	154 (5.7)	98 (3.6)	393 (14.6)	2698 (100)
1980-88	1375 (20.5)	1238 (18.5)	1974 (16.1)	631 (9.4)	328 (4.9)	339 (5.1)	364 (5.4)	1339 (20.0)	6688 (100)

Note: Figures in parenthesis show percentage share of each country
Source: India Investment Centre, New Delhi.

According to Table 5 total value of FDI approved from all the sources rose phenomenally from Rs.21.18 cr. during 1974-77 to Rs.580.49 cr. during 1985-88. A country wise composition of approved value of FDI shows that during 2974-75 first four largest foreign investors in India were the USA, the FRG, France and the UK in the descending order of the share of their investments. During 1985-88, also the USA and the FRG retained their position as the first two largest investors as before but Japan and Italy occupied the third and fourth places pushing the UK and France to the fifth and sixth places.

Table 5: Source countrywide distribution of amount of FDI approved

(Rs.crore)

Home	1974	1975	1976	1977	74-77 (Cum)	1985	1986	1987	1988	1985-88 (Cum)
USA	1.93	1.20	4.42	1.82	9.37	39.93	29.37	29.52	97.14	195.96
FRG	0.60	0.69	0.98	0.75	3.02	11.81	20.16	9.87	31.00	72.84
France	1.39	0.17	0.71	0.01	2.28	2.36	2.05	5.35	11.78	21.54
UK	0.51	0.11	0.56	0.67	1.85	3.71	7.72	8.45	13.91	33.79
Italy	0.56	0.07	0.24	0.24	1.11	6.95	2.33	2.97	27.87	40.12
Switzerl.	0.75	0.33	-	0.41	-	0.84	3.25	8.85	2.74	15.68
Japan	0.47	0.13	-	-	-	15.68	5.62	6.91	17.43	45.64
Others	0.50	0.50	0.36	0.10	3.55	44.79	36.45	35.79	37.89	154.92
Total	6.7	3.2	7.3	4	21.2	126.1	106.9	107.7	239.8	580.5

Sources: 1. Quarterly Bulletin of Statistics, April 1978; 2. Report on Currency and Finance, Vol.1988-89

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IV. **Why Liberalization?**

With the success of outward oriented growth strategy as reflected in the growing industrial capabilities of the newly industrialized countries (NICs), our policy makers began to recognize the need for change in the industrial and trade policies for achieving higher growth rate. It was particularly felt that unless we increase the exports of our manufactures substantially, we would not be able to achieve a respectable high growth rate. It was also recognized that under the given conditions of production, which employ often outmoded technology and with the domination of the MNEs in the market for technology and distribution channels in the world it would be hard for the Indian exporters to penetrate into international markets, especially in the markets of industrialized countries. To deal with these situations, the GoI during the eighties permitted liberal imports of raw material, machinery, equipment and technology and also encouraged FDI. The former led to the widening of trade and current account deficits, alarmingly faster especially after the mid-eighties, which were largely financed through the commercial borrowings in the international market.

A cursory peep into Table 6 reveals that, during the Sixth Five Year Plan (1980-81 to 1984-85), the current account deficits averaged at Rs. 2467.1 crore per annum. This represented 1.3 per cent of the country's GDP. There was a further sharp rise in current account deficits in the first four years of the Seventh Five Year Plan (1985-86 to 1988-89), it is estimated to have averaged at Rs.6762.5 cr. or 2.1 per cent of GDP. Table also shows an increasing trend in the approvals of India's commercial borrowings from 1980-81 onwards. The total approvals over the Sixth Five Year Plan period aggregated to Rs.7259 cr. or Rs.1451.8 cr. per annum, which rose to Rs.10,064 cr. or Rs.2516 cr. per annum in the first four years of the Seventh Plan. These borrowings involved higher interest costs and short maturity period. As a result, debt servicing on all external borrowing as a percentage of current receipts has increased from 8.5 per cent in 1979-80 to 12.1 per cent in 1984-85 and 24 per cent in 1987-88. The current account deficits almost entirely are being covered by commercial borrowings from abroad. Moreover, plans are being made to ensure a gross capital inflow of at least Rs.1200 cr per annum during the Eight Plan just with a view to contain the current account deficit to 1 per cent of GNP. If this amount of capital inflow is again decided to be financed largely by external commercial borrowings it is likely to lead the country into an external debt trap. As the concessional loans are not available in sufficient amount, the only viable option left is to attract more FDI and NRI funds, even if they do not bring technology with them, to redress the situation on the balance of payments front.

Table 6 : Trade deficits, current account deficits and external commercial borrowings

(Rs. crore)

Year	Trade deficits	Current account deficits (Net)	External commercial borrowings
1980-81	5813.0	1656.6	1038
1981-82	5868.0	2817.9	1204
1982-83	5448.0	2746.1	2026
1983-84	5898.0	2262.4	1086
1984-85	5390.0	2852.4	1906
1986-87	7749.0	5830.0	1396
1987-88	6658.0	6292.6	2654
1988-89	7412.0	9000.0	4314

Sources: 1. GoI, Ministry of Commerce, DGCIS, 1989-90; 2. GoI, Economic Survey, 1989-90

Therefore, GoI aims at increasing the inflow of FDI from its present level to $ 1000 million a year in the Eighth Five Year Plan period. The arguments in favour of recent efforts of the GoI for attracting larger inflow of FDI rather than going for more commercial borrowings are being put forward as follows: i) The equity financing requires payments to be made only when the investment earns a profit, while debt requires interest payments to be made irrespective of the investment performance; (ii) The payments under FDI can be regulated by the host country government, while the payments on debt are outside the purview of its control, because the interest rate changes depend on international financial market (Rana 1987); (iii) Only a portion of FDI is repatriable, while debt payment requires the whole sum of principal and interest obligations; (iv) Net inflow of FDI in India is very low in comparison to her absorption capacity.

V. Summary and Concluding Remarks

In sum, government policy towards foreign collaborations and foreign direct investment, which remained very restrictive during the 1970s, has been considerably liberalized during the 1980s. Interestingly, this change was brought about without amending the FERA. The liberalization has led to a phenomenal increase in the number of foreign collaborations approved, foreign investment involved in the collaboration agreements and net inflow of FDI in India. The provisions of FERA have guided the bulk of FDI inflows to technologically advanced industries. As in the 1970s, the USA followed by the FRG, the UK and Japan remained most dominant foreign investor in India during the 1980s. Yet, the source of foreign investment in India got more diversified during the latter 1980s.

Although the initial attempt towards the liberalization of FDI policy in the 1980s was aimed at improving the export performance and overall competitiveness of the economy, the recent efforts of the National Front government for further liberalisation is primarily guided by its apprehension that the additional borrowings in international financial market for financing current account deficits will lead India towards "debt-trap". The tempo of the liberal policy, the author feels, should be continued with a view to allowing the FDI to yield those benefits as explained in Section I including the purpose

for which it was undertaken initially. However, the continuation of this liberal attitude in the long run will depend upon the following conditions, whether: (1) the foreign investors bring in substantial amount of fresh capital or generate capital mostly from reinvested earnings of existing subsidiary companies or fulfill their investment requirements by borrowing in domestic capital market; (2) the purchase of technology involves very high costs to the economy as the market for technology is dominated by a few oligopolistic firms; (3) the transferred technology corresponds to the factor endowments of India; (4) the labour intensive part of production process is shifted or not; (5) the foreign collaboration agreements through which FDI is channeled impose many restrictive clauses on exports from local firms; (6) the MNEs, with the given large domestic market of India, exploit market opportunities or help in augmenting India's exports through their worldwide distribution network; (7) the repatriation in terms of dividends and profits, payment for royalty and lumpsum/technical fees and imported inputs as part of the collaboration agreements put together are so high as to make net foreign exchange earning negligible or negative; (8) the FDI increases healthy competition in the economy or strengthens the monopolistic structure and encourages rent-seeking activities; (9) the ideological and political considerations predominate over the hard economic realities facing the Indian economy.

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