Role of FDI in Economic development of India

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Abstract

Foreign Direct Investments plays an important role in the economic development of a country. There are certain components which influence the Foreign Direct Investments. It comprises of Trade openness, Inflation rate, Economic stability, Investment policies, rules and regulations adopted, implemented Exchange rates, foreign reserves and Political stability of the country. The capital inflow of foreign investors allows strengthening infrastructure, increasing productivity and creating employment opportunities in India. Additionally, FDI acts as a medium to acquire advanced technology and mobilize foreign exchange resources. Availability of foreign exchange reserves in the country allows RBI (the central banking institution of India) to intervene in the foreign exchange market and control any adverse movement in order to stabilize the foreign exchange rates. As a result, it provides a more favourable economic environment for the development of Indian economy.

Keywords: *FDI, Benefits, Economic Development.*

1. INTRODUCTION

Foreign direct investment in India is a major monetary source for economic development in India. Foreign companies invest directly in fast growing private auspicious businesses to take benefits of cheaper wages and changing business environment of India. Economic liberalisation started in India in wake of the 1991 economic crisis and since then FDI has steadily increased in India,[1][2] which subsequently generated more than one crore (10 million) jobs .For a multinational corporation, FDI in India is a means to access new consumption and production markets, and thereby expand its influence and business operations. It can gain access not only to limited resources such as fossil fuels and precious metals, but also skilled and unskilled labour, management expertise and technologies. FDI also enables an organisation to lower its cost of production- by accessing cheaper resources, or going directly to the source of raw materials rather than buying them from third parties. Often, there are various tax advantages that accrue to a company undertaking FDI. This can occur when the home country allows tax deduction on foreign income, or when the recipient country allows tax deductions and benefits for organisations incurring FDI in that country. Additionally, this can happen when the recipient country has a more beneficial tax code than the home country. Foreign Direct Investments (FDIs) give rise to the returns in production through positive externalities towards the sustainable economic growth. (Mengistu and Adams)

2. RESEARCH METHODOLOGY

Information for Research paper has been taken from secondary data like articles related to FDI from sources such as newspapers, Journals, textbooks, internet.

3. REVIEW OF LITERATURE

Gregorio, and Lee, (1998) studied impact of Foreign Direct Investments on economic growth.

Further **Basu, Chakraborty and Reagle** (2003) have stated that that there is a co integration relationship between Foreign Direct Investment and Gross Domestic Product.

Chowdhury and Mavrotas (2005) examined the relationship between Foreign Direct Investment and economic growth. And indicated positive impacts on economy.

Malhotra (2014) identified the impact of FDI on Indian Economy and analyses the challenges of Foreign Direct Investments.

Silajdzic and Mehic (2015) stated positive impact of FDI towards on economic growth directly by subscribing to the fixed capital formation and indirectly subscribing to the knowledge stocks .Domestic investments and investments were affected due to FDI.

4. OBJECTIVES

1. To study concept of FDI
2. To study benefits of FDI in the economy of India
3. To identify role of FDI accelerating economy of India
4. Conclusion

1.) Concept of FDI

Foreign direct investment (FDI) is where an individual or business from one nation, invests in another. This could be to start a new business or invest in an existing foreign owned business. For instance, Mr Bloggs from the US has $1 million and wants to start a new company in Germany. He invests this, creating a new clothing manufacturing firm in the country. This would classify as a FDI. However, the definition is slightly different when it comes to investing in a foreign companies assets. According to the IMF, a foreign direct investment is where the investor purchases over a 10 percent stake in the company. Foreign Direct Investment (FDI) leads to the long term growth of the economy. MNCs bring about technology transfer to the domestic companies. Organic growth or expansion takes place in the companies. Employment too rises. FDI strengthens the balance sheet as it raises the assets of the companies. Profits of the businesses increase and labour productivity too increases. Per capita income increases and consumption improves. Tax revenues increase and government spending rises. GDP increases and there is also a lagged effect due to which subsequent years GDP too increases. Furthermore investment has gestation period and returns increase after few years Balanced and unbalanced growth theories of Development economics too harp on this. So is Leibenstein's minimum effort hypothesis. FDI also acts as a solid complement to domestic stock of investment which is low (about 32%) in India because of low savings. This investment raises competitiveness among the businesses, breeds innovation and efficiency and increases standard of living through better products and services in the market. Exports get a fillip and balance of payments show surplus which causes rupee to appreciate vis a vis the Dollar. Forex reserves rises significantly and this causes RBI 's assets to increase due to which money supply rises and thus inflation too rises according to Quantity Theory of Money. So according to Mundell Fleming model in the open economy context, bond prices go up, interest rates go down, investment escalates further and growth rises. In FDI there is technology transfer or the movement of technical know how to the domestic country due to which skill development takes place and together with higher capital this raises productivity and profitability.

Types of Foreign Direct Investment

Foreign direct investments have 4 types as being Horizontal, Vertical, Conglomerate and Platform FDI.

A.) Horizontal Investments:

- A horizontal direct investment refers to the investor establishing the same type of business operation in a foreign country as it operates in its home country.
- Thus, horizontal FDI occurs when the multinational firm undertakes the same production activities in multiple countries.
- **Example:** Apple based in the United States opens stores in India that would be called horizontal investment. Also, Coke, Pepsi, Samsung, HSBC etc expanded internationally by way of horizontal FDI.

B.) Vertical Investments:

- A vertical investment is one in which different but related business activities from the investor's main business are established or acquired in a foreign country.
- Vertical FDI takes place when the multinational fragments the production process internationally, locating each stage of production in a country with the least cost.
- There are 2 types of Vertical FDIs : Forward Vertical FDI & Backward Vertical FDI
  - ✓ **Forward Vertical FDI :** In this, the FDI brings the company nearer to a market. For example, Toyota buying a car distributorship in America.
  - ✓ **Backward Vertical FDI :** In this, the international integration goes back towards raw materials. For example, Toyota getting majority stake in a tyre manufacturer or a rubber plantation.

C.) Conglomerate Investments:

- A conglomerate type of foreign direct investment is one where a company or individual makes a foreign investment in a business that is unrelated to its existing business in its home country.
- Thus, in conglomerate investments, a business acquires an unrelated business in a foreign country. This is uncommon as it requires overcoming two barriers to entry: entering a foreign country and entering a new industry or market.

D.) Platform FDI :

- In a Platform type of FDI, a business expands into a foreign country but the output from the foreign operations is exported to a third country. This is also referred to as **Export-Platform FDI.**
- Platform FDI commonly happens in low-cost locations inside free-trade areas.
- For example, if Ford purchased manufacturing plants in Ireland with the primary purpose of exporting cars to other countries in the EU.

2.) Benefits of FDI

There are many ways in which FDI benefits the recipient nation:

i.) Increased Employment and Economic Growth

It is also one of the most important reasons why a nation, especially a developing one, looks to attract FDI. Increased FDI boosts the manufacturing as well as the services sector. This in turn creates jobs, and helps reduce unemployment among the educated youth - as well as skilled and unskilled labour - in the country. Increased employment translates to increased incomes, and equips the population with enhanced buying power. This boosts the economy of the country.

ii.) Human Resource Development

Human Capital refers to the knowledge and competence of the workforce. Skills gained and enhanced through training and experience boost the education and human capital quotient of the country. Once developed, human capital is mobile. It can train human resources in other companies, thereby creating a ripple effect.

iii.) Development of Backward Areas

FDI enables the transformation of backward areas in a country into industrial centres. This in turn provides a boost to the social economy of the area. The Hyundai unit at Sriperumbudur, Tamil Nadu in India exemplifies this process.

iv.) Provision of Finance & Technology

Recipient businesses get access to latest financing tools, technologies and operational practices from across the world. Over time, the introduction of newer, enhanced technologies and processes results in their diffusion into the local economy, resulting in enhanced efficiency and effectiveness of the industry.

v.) Increase in Exports.

The creation of 100% Export Oriented Units and Economic Zones have further assisted FDI investors in boosting their exports from other countries.

vi.) Exchange Rate Stability

The constant flow of FDI into a country translates into a continuous flow of foreign exchange. This helps the country's Central Bank maintain a comfortable reserve of foreign exchange. This in turn ensures stable exchange rates.

vii.) Stimulation of Economic Development

FDI is a source of external capital and higher revenues for a country. When factories are constructed, at least some local labour, materials and equipment are utilised. Once the construction is complete, the factory will employ some local employees and further use local materials and services. The people who are employed by such factories thus have more money to spend. This creates more jobs. These factories will also create additional tax revenue for the Government, that can be infused into creating and improving physical and financial infrastructure.

viii.) Improved Capital Flow

Inflow of capital is particularly beneficial for countries with limited domestic resources, as well as for nations with restricted opportunities to raise funds in global capital markets.

ix. Creation of a Competitive Market

By facilitating the entry of foreign organisations into the domestic marketplace, FDI helps create a competitive environment, as well as break domestic monopolies. A healthy competitive environment pushes firms to continuously enhance their processes and product offerings, thereby fostering innovation. Consumers also gain access to a wider range of competitively priced products.

3) Role of FDI in accelerating economy of India

FDI helps in accelerating the rate of economic growth as follows:

i.) FDI provides Capital:

Foreign Direct Investment is expected to bring needed capital to developing countries. The developing countries need higher investment to achieve increased targets of growth in national income .Since they cannot normally have adequate savings, there is a need to supplement savings of these countries from foreign savings. This can be done either through external borrowings or through permitting and encouraging Foreign Direct Investment. Foreign Direct Investment is an effective source of this additional capital and comes with its own risks.

ii.) FDI removes Balance of Payments Constraint:

FDI provides ‘ inflow of foreign exchange resource and removes the constraints on balance of payment. It can be seen that a large number of developing countries suffer from balance of payments deficits for their demand for foreign exchange which is normally far in excess of their ability to earn. FDI inflows by providing foreign exchange resources remove the constraint of developing countries seeking higher growth rates.

FDI has a distinct advantage over the external borrowings considered from the balance of payments point of view. Loan creates fixed liability. The governments or corporations have to repay. The resulting international debt of the government and the corporation parts a fixed liability on balance of payments.

This means that they have to repay loans along with interest over a specific period. In the context of FDI this fixed liability is not there. The foreign investor is expected to generate adequate resources to finance outflows on account of the activity generated by the FDI. The foreign investor will also bear the risk.

iii.) FDI brings Technology, Management and Marketing Skills:

FDI brings along with it assets which are crucially either missing or scarce in developing countries. These assets are technology and management and marketing skills without which development cannot take place. This is the most important advantage of FDI. This advantage is more important than bringing capital, which perhaps can be had from the international capital markets and the governments.

iv.) FDI promotes Exports of Host Developing Country:

Foreign direct investment promotes exports. Foreign enterprises with their global network of marketing, possessing marketing information are in a unique position to exploit these strengths to promote the exports of developing countries.

v.) FDI provides Increased Employment:

Foreign enterprises by employing the nationals of developing countries provide employment. In the absence of this investment, these employment opportunities would not have been available to many developing countries. Further, these employment opportunities are expected to be in relatively higher skill areas. FDI not only creates direct employment opportunities but also through backward and forward linkages, it is able generate indirect employment opportunities as well.

vi.) FDI results in Higher Wages:

FDI also promotes higher wages. Relatively higher skilled jobs would receive higher wages.

vii.) FDI generates Competitive Environment in Host Country:

Entry of foreign enterprises in domestic market creates a competitive environment compelling national enterprises to compete with the foreign enterprises operating in the domestic market. This leads to higher efficiency and better products and services. The Consumer may have a wider choice.

5. CONCLUSION

Foreign Direct Investments plays a significant part of Indian Economic Growth. In the 2013-14 budget speech, for example, the government was more honest to admit that FDI was imperative more because of the need to finance the current account deficit (CAD). Since then it has been claimed that the FDI is boosting manufacturing and employment but on multiple occasions the government has told the Lok Sabha that it has "no data" to substantiate any such claims. Prof KS Chalapati Rao of the Institute for Studies in Industrial Development, who has been studying FDI for decades says: "There has been no mechanism to tell what the FDI is doing in this country, especially in regards to technology transfer and employment".

He points to the observations of several government documents to drive home his point. The 2008 report of the Prime Minister's Group (V Krishnamurthy) said there was "little or no emphasis" on technology transfer or whether the kind of technologies being brought in was "appropriate or not". Quite often, it said, the technologies bought in were not the state-of-the-art technologies but at least one or two generations older. Therefore, it asked for "a relook at our FDI policy in terms of the technological benefits the country needs to derive". The Government of India has amended FDI policy to increase FDI inflow. In 2014, the government increased foreign investment upper limit from 26% to 49% in insurance sector. It also launched Make in India initiative in September 2014 under which FDI policy for 25 sectors was liberalised further. As of April 2015, FDI inflow in India increased by 48% since the launch of "Make in India" initiative. FDI in defence India was ranking 15th in the world in 2013 in terms of FDI inflow, it rose up to 9th position in 2014[1] while in 2015 India became top destination for foreign direct investment. The Department for Promotion of Industry and Internal Trade and Invest India has developed the India Investment Grid (IIG) which provides a pan-India database of projects from Indian promoters for promoting and facilitating foreign investments.

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