# FOREIGN DIRECT AND PORTFOLIO INVESTMENT FLOWS AND DEVELOPMENT: A PERSPECTIVE ON INDIAN EXPERIENCE

NAGESH KUMAR

# What is FDI?

- FDI refers to the physical investments made by foreign investors in the domestic country. The physical investments refer to the direct investments into building, machinery and equipment.
- Reserve bank of India (RBI) defines FDI as a process whereby resident of one country (i.e. home country) acquires ownership for the purpose of controlling production, distribution and other activities of a firm in the another country.(i.e. the host country).
- In India there are three important element of FDI:

(a) Equity investments by foreign investors;

(b) Reinvested earnings i.e retained earning of FDI companies;

(c) Debt Investment (particularly the inter-corporate debt between related entities).

# What is FPI?

- FPI refers to the short-term investments by foreign entity in the financial markets. These are indirect investments and include investment in tradable securities, such as shares, bonds, debenture of the companies.
- Foreign Portfolio investors don't exert management control on the enterprise in which they invest.
- There are three kinds of FPI in India:

a) **Foreign Institutional Investment**: These are the investments made by foreign institutions like pension funds, foreign mutual funds etc. in the financial markets.

b) **Funds raised through Global Depository Receipts or American Depository Receipts (GDRs/ADRs)**: GDRs and ADRs are instruments which signify the purchase of share of Indian companies by foreign investors or American investors respectively.

c) **Off-shore funds**: The schemes of mutual funds that are launched in the foreign country.

# Foreign Direct Investments (FDI) vs. Foreign Portfolio Investment (FPI)

(a) FDI accelerates growth process mainly due to superior technology transfers and greater competition that generally accompany FDI. FDI also improves export competitiveness of the country. So, FDI has a positive spillover effects on the economy. FPI enables the country to use huge pooled foreign funds and directly doesn't involve any kind of superior technology or managerial transfers. Thus FPI has limited spillover effects than FDIs.

(b) FDI reflects seriousness and commitment on part of foreign investors since FDI causes high initial set up cost and higher exit costs in terms of difficulty in selling stake in the firm. Thus foreign direct investor stay invested for long-term in the country and so help to improve growth prospects of the country. FPI is guided by short-term gains and involves problems to exit the country. FPI tends to be more volatile than direct investments. The sudden FPI outflows at the time of domestic crisis may disrupt the development process of the country.

# Foreign Direct Investments (FDI) vs. Foreign Portfolio Investment (FPI)

(c) Portfolio investors due to their short-term perspective may indulge into speculative activities in the domestic financial market and may cause problems for the domestic investors.

(d) FDIs are directly managed by foreign owners FPI on the other hand are managed by “outside managers”. So FDI results into better asset management.

(e) The increased FDI flows give positive signal about the long-term prospects of domestic economy and greater creditability of the country. A very substantial amount of FPI of short-term nature depicts risk in the domestic economy.

# EVOLUTION OF THE FDI POLICY

1. **1950-1960s**

- Soon after Independence, when India embarked on a strategy of import substituting industrialization, with a focus on heavy industries. Given the paucity of technology, skills and entrepreneurial experience, India's attitude towards FDI was increasingly receptive.
- FDI was sought on mutually advantageous terms, though the majority local ownership was preferred.

2. **1960-1970s**

- The government adopted a more restrictive attitude towards FDI in the late 1960s, as the local capacity improved through a process of import substitution, and as the outflow on account of dividends, profits, royalties, technical fee etc., grew sharply.

- Restrictions were put on proposals unaccompanied by technology transfer and those seeking more than 40% foreign ownership.
- From 1973 onwards, the further activities of foreign companies (along with those of local large industrial houses) were restricted to a select group of core or high priority industries.
- The FERA [Foreign Exchange Regulation Act] of 1973 required all foreign companies operating in India to register under the corporate legislation with up to 40% foreign equity.
- Exceptions from the general limit of 40% were made only for the companies operating in high priority or high technology sectors, tea plantations, or those producing predominantly for exports.

**3. 1980s**

- In the 1980s, the attitude towards FDI began to change as part of the strategy of modernization of industry with liberalized imports of capital goods and technology, exposing the India industry to competition and assigning a greater role to MNEs in the promotion of manufactured exports.

- The Policy changes adopted in the 1980s covered liberalization of Industrial licensing (approval) rules, a host of incentives and exemptions from foreign equity restrictions, under FERA to 100% export-oriented units and some flexibility in foreign ownership.

4. **1990s onwards**

- The New Industrial Policy (NIP), announced on 24th July 1991, marked a major departure with respect to FDI policy, with in general abolition of licensing and automatic clearance for some types of FDI that fulfilled the conditions laid down, and opening up of some new sectors, such as mining, telecommunication, railways, airlines, ports etc. subject to sectoral caps.
- Foreign ownership in most industries was allowed, in some cases even on an automatic basis, but some like defence equipment and items reserved for small scale industry remained restricted to 26 % and 24% respectively.

- Since then, further steps have been taken to remove more restrictions on FDI. For example, civil aviation was opened up, FDI was also allowed in multi-brand retail to some extent, sectoral caps have been revised upward, in some sectors like telecom to even 100%.
- In 1992, guidelines for investments by FII were announced by the government. FII were allowed to invest in all types of securities with full repatriation benefits. In June 2013, FII investments were reclassified as FPI, which is subject to their holding in a company within 10% of its equity. Any holding beyond 10% will qualify as FDI.
- The policy towards outward investment has also been liberalised since 1991. With the build of foreign exchange, the limits for outward investments have been gradually relaxed and Indian enterprises are now permitted to invest abroad up to 100% of their net worth on automatic basis.
- India has also entered into 88 Double Taxation Avoidance Treaties, and Bilateral Investment Promotion and Protection Agreements (BIPAs) with 82 countries.

# Determinants of FDI Inflow

- market size
- extent of urbanization
- quality of infrastructure
- geographical and cultural proximity with major sources of capital
- policy factors, e.g. tax rates, investment incentives etc.

# Disadvantages India has

relatively low income levels

low level of urbanization

Relatively poor quality of infrastructure

poor geographical and cultural proximity with major sources of capital

# Trends in FDI

- FDI inflows have been growing in India since 1991, but the big break came in 2006, when annual inflows to the country nearly tripled in one year from $7.6 billion, to $20 billion and peaked to $47 billion in 2008 before declining to $27 billion 2010 in the wake of global financial crisis but recovering to $36.5 billion in 2011 and then declining again to $28 billion in 2013.
- Since then (2013) there has been a recovery. It rose to $35 billion in 2014 and to $44 billion in 2015, $42 billion in 2016 and $45 billion in 2017 thus being the 10th largest recipient of FDI in the world.
- India's share in global FDI inflows nearly doubled over 2005-06 and again between 2006 and 2009 to nearly 2.9% before declining to 1.9% in 2013 and rose to about 2.5% in 2015.

Amount of Foreign Investment (in US $ million)

| 2008-09 | 2009-10 | 2012-13 | 2015-16 |
|---|---|---|---|
| 19.8 | 17.9 | 19.8 | 36.9 |

# QUALITY OF FDI INFLOWS

- **SECTORAL COMPOSITION**

In terms of sectoral composition of FDI inflows, there is a shift since 1991 in India's case.

a. Earlier the bulk of FDI inflow used to be directed to manufacturing especially the high technology industry through a selective policy.

b. After the liberalization, a substantial proportion of FDI inflow has been directed to services. Although Manufacturing still receives slightly higher proportion of FDI (around 40%), services is fast catch up (35%).

c. Also, amongst the manufacturing subsectors:

i. After 1991,FDI is more evenly distributed between food and beverages, transport equipment, metals and metal products, electrical and electronics etc.

ii. This stands in contrast to the situation where before 1991, there was heavy concentration in relatively technologically intensive sectors viz., machinery, chemicals, electrical and transport equipment

## ❖IMPACT OF ON GROWTH AND DOMESTIC INVESTMENT

- FDI inflows could contribute to growth rate of the host economy by augmenting the capital stock as well as with infusion of new technology.
- In case of India, FDI inflows received by India have been of mixed type, combining some inflows that crowded in investment and some crowded them out.

## ❖FDI AND EXPORT PLATFORM PRODUCTION

- According to Nagesh Kumar, until 2007, the bulk of FDI inflow in India are market seeking, and the share of foreign affiliates in exports until 2007 was around 10% but the MNEs (Multinational Economies) in India are beginning to exploit the potential of India as base for export-oriented production.
- India has not imposed explicit export obligations on MNE affiliates except for those entering the products reserved for SMEs, Indirect export obligations in the form of dividend balancing(thus obliging the firms to export at least enough to neutralize adverse BOP effect) were imposed for enterprises producing primarily consumer good but was withdrawn in the year 2000.

# FPI INFLOW & ITS IMPACT

- Large amounts of Portfolio investments in the form of short term equity investments by FII flowed into India as the Indian economy gathered momentum and capital markets started giving attractive returns. The annual net inflows are highly volatile.
- According to Nagesh Kumar, besides volatility, FII inflows have a very high servicing burden, much higher than all other foreign resources, such as foreign borrowings, NRI deposits, ADRs and GDRs.
- While it is generally believed that FII help a country to build its foreign exchange reserves, Kumar feels that exposure to these foreign inflows also enhances the need to have larger foreign exchange reserves due their highly volatile nature.

**Net Portfolio Investment in India (US $ Million)**

| 2003-04 | 2004-05 | 2005-06 | 2006-07 | 2007-08 | 2008-09 | 2009-10 | 2010-11 | 2011-12 | 2012-13 |
|---|---|---|---|---|---|---|---|---|---|
| 11377 | 9291 | 12492 | 6947 | 27434 | -14032 | 32396 | 30292 | 17171 | 26891 |

# POLICY LESSONS

- According to Nagesh Kumar, the following policy lessons can be drawn from the above discussion.

- First, liberalization of FDI policy may be necessary but not sufficient for expanding FDI inflows.

i. The overall macroeconomic performance continues to exercise a major influence on the magnitude of FDI inflows.

ii. Studies have shown that policies that facilitate domestic investments also attract FDI inflows.

iii. Also, active promotion of FDI by developing certain viable projects and getting key MNEs interested in them could be useful in attracting investments in desirable directions.

# POLICY LESSONS

- Secondly, evidence suggests that government policies play an important role in determining the quality or developmental impact of FDI. The various performance requirements have been employed by the governments to achieve their development policy objectives, such as,

i. phased manufacturing programmes

ii. export performance requirements and

iii. domestic ownership requirements.

- Thirdly, one way to maximize the contribution of FDI to host's development is to improve the chances of FDI crowding-in domestic investments and minimize the possibilities of it to crowd them out Especially since export oriented FDI minimizes the possibility of the MNEs crowding out domestic enterprises and may generate favourable spillovers for domestic investments.

# POLICY LESSONS

❖Another similar policy that can help maximizing the contribution of FDI is to push them to newer areas where the local capabilities do not exist as such a policy minimizes the chances of conflict with domestic investments and in fact generate favourable externalities for them. Also some governments discourage brownfield investments to reduce conflict.

❖ Another way to maximize gains from FDI would be through diffusion of knowledge from MNEs to local enterprises.

a. An important channel of diffusion of knowledge bought in by MNEs is vertical inter-firm linkages with domestic enterprises.

b. Sometimes diffusion is brought about by the government's imposition of local content requirements and sometimes through means of proactive measures taken by the government that encourage foreign and local firm to deepen their local content. This policy has been successful in Singapore, Taiwan and Korea and Ireland.

c. The knowledge diffusion could also be accompanied by creating sub national or sub-regional clusters of interrelated activities which facilitated which facilitate the spill overs of knowledge through informal and social contacts amongst employees besides traditional buyer seller links.

# POLICY LESSONS

- Building local capabilities by education, training in technical disciplines, centres of excellence, innovation centres etc. have substantial favourable externalities as is demonstrated by the case study of FDI in India's knowledge-based industry.
- Finally, one needs to also take stock of CAD(Current Account Deficit).

a. After all the competitiveness of exports is an important aspect of controlling the CAD.

b. A stable exchange rate with a mild tendency towards depreciation can be helpful.

c. Distortions such as inverted duty structures need to be removed and flow of trade finance needs to be strengthened.

d. In a situation of slowdown in the world economy, a major expansion of exports can be challenging, given an environment of excess capacities.

e. It can lead to growing threat of protectionism and temptation of dumping by those with deep pockets.

f. On the import side while there are inelastic essential imports like fuels and raw materials, attention needs to be paid to fast growing imports like electronics, non electrical machinery, defence equipment that provide opportunity for strategic import substitution (Make in India campaign).

# Review Questions

Q1. Discussing the advantages and disadvantages of FDI, analyse the Indian government's evolving policies on the same.

Q2. Analyse the trends in FDI inflows in India. What is the role of government policy in attracting FDI inflows for development?

Q3. What do you mean by FDI? Briefly discuss the FDI policy and its performance in India.