Chapter-1

INTRODUCTION AND BACKGROUND OF THE STUDY

Traditional models of trade in goods and services assumed that factors of production such as labor and capital were not internationally traded. In recent times, however, international labor movement (migration) and international capital movement (foreign investment) have become the order of the day due to globalization of world economies. Foreign direct investment and skilled labor have, perhaps, become most traded factors of production. The growing importance of Foreign Direct Investment (FDI) is because ofthe facts that in addition to the direct capital financing, it can be a source of valuable technology and know-how that may foster economic growth of recipient country. Moreover, it can supplement the host country's(particularly the capital deficient developing countries like India) resources and provide valuable injection in the process of capital formation. FDI not only increases the quantum of production but also increases the quality of products that can be further traded in international market. Therefore, it helps to promote exports of host country and in turn becomes a source of foreign exchange earnings. Among the other benefits, FDI provides employment opportunities, strengthening the industrial base and competitiveness and acceleration of development of various sectors and regions.

According to the Balance of Payments and International Investment Position Manual, Sixth Edition (BPM6) of the International Monetary Fund (IMF), "Foreign Direct Investment (FDI) is a category of cross-border investment associated with a resident in one economy having control or a significant degree of influence on the management of an enterprise that is resident in another economy."

The world economy is welcoming FDI with FDI favorable policy. Moreover, trade policy is also becoming more flexible by evading tariffs and trades barriers. The FDI efficiency in promoting growth also depends on trade policy.[1] Most of the countries liberalized their

[1]Bhagwati (1985) explained, under export promotion (EP) strategy FDI is likely to be more efficient than under import substitution (IS) strategy. This is because, first in the country IS strategy the effective exchange rate on import exceeds the effective exchange rate of export and is biased in favour of IS

economics, reformed their institutions and improved infrastructure facilities to attract more FDI inflows. However, India, the late comer in this process, has initiated its economic reforms in 1991 only and opened the door widely for the multinational companies (MNC). The motive behind allowing FDI was to; despite complimenting to domestic investment this will intensify the quality of products through infusion of modern technology and known how and make the product tradable at international market. Therefore, it becomes a source of foreign exchange earnings through promoting exports. The total inflows of FDI in 1991 was just US $ 97 million, which increased to US $ 315 million in 1992-93,and it further rose to around $ 2, 30,909 million in 2009-10.[2] Consequently, India has registered significant growth rate in post reform period.

Though India has gradually changed its policy towards FDI, allowing FDI to new sectors and removing caps gradually but it is more worthwhile to see how far India's FDI policy could be able to attract more foreign investors to invest in India?Whether FDI flow in India is growth oriented? Ambiguous relationship between FDI and economic growth was identified by earlier literature. This massive increase in FDI in India during an era of liberalization raises important research questions about the possible effect of FDI on economic growth in India. There is an immense literature on growth theory, dealing with the effect of FDI on economic growth in developing countries. The recent developments in endogenous growth literature tend to suggest that long run growth can result from more open liberalized government policies conducive for the inflow of foreign capital. Inflow of FDI can be an important vehicle for technological change and accumulation of human capital.

FDI link with economic growth is through various channels. FDI may complement domestic investment through forward and back ward linkages[3] that will further contribute to economic growth. For instance, FDI inflow to final goods will create scope for investment in intermediary goods. FDI comes with modern technology can have spillover effect on domestic firms. The local firm will learn directly from watching them or

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strategy. Second EP strategy allows operating a distortion-free environment that is more favorable for FDI.

[2] World Development Report, 2009, World Bank

[3] Agrawal, P. (2002) found a complementary relationship between FDI and domestic investment in South Asian region.

through transformation of labor. Moreover, FDI can assist the domestic firms to access international market. Infusion of superior technology will increase the quality of the product and make it compatible at international level.

Nevertheless, the policy maker should be careful in inviting FDI, because FDI may have negative effect on economic growth. There is a possibility of crowding-out effect on domestic investment.[4] MNCs are technologically sound than domestic firms. As a result of this FDI will dominates market share and drive the domestic firms out of market. This will be harmful to the domestic economy in long run prospective. However, FDI also face competition from domestic firms.[5]It is difficult to find the direct and indirect effect on growth. Its link with growth is through various channels. This study, therefore, examine the impact of FDI on overall growth.

There is a vast difference among the countries with respect to the nature and quality of data, which make a cross-country comparison a risky business. Moreover, the policy towards FDI differs from country to country. Therefore, it needs a systematic time series analysis of individual country. The purpose of this study to examine the effect of FDI on economic growth using yearly and quarterly time series observation is because of this reason. The annual observation from 1980 to 2009 has been chosen to reveal the growth impact of FDI according to change in policy. While quarterly observation will explore the growth impact of FDI in recent decades.

1.1 Statement of the problem

Despite a large amount of literature on the subject, the role of FDI in economic growth remains highly controversial. The proponents of FDI argue that FDI helps to promote economic growth through technology diffusion and crowding in domestic investment (Borensztein, De Gregorio and Lee 1998; Agrawal 2000; Tang, Selvanathan and Selvanathan 2008; Mileva 2010). However, some other studies find an adverse impact of FDI on economic growth through crowding out domestic investmentor no

[4] In a cross section study, Kumar and Pradhan (2005) found crowding out effect of FDI on domestic investment.

[5] Some work like Ganesh (1997) find MNCs face tough competition from domestic firms. For example Tang, a prestigious brand belonging to General Foods of US, could not cope with competition from Rasna, an Indian brand.

significant role (Patibandal and Sanyal 2000; Kumar and Pradhan 2002; Chakraborty and Basu 2002).

India has adopted not only liberal attitude towards FDI but is also giving much incentives to the foreign investors. In post liberalization period, Indiais achieving a significant economic growth. This raise an important question whether the government's policy towards FDI should continue in the interest of economic growth or not. Moreover, it needs to be examined whether FDI contribution to economic growth is equal to that of domestic investment. Based on the above considerations, this study framed these objectives.

1.2 Objectives of the Study

The study proposes to fulfill the following objectives;

1) to point out gaps if any, in earlier literature regarding FDI and economic growth,
2) to analysis the government policy towards FDI in India,
3) to examine the impact of FDI and domestic investment on economic growth in India and
4) todraw some policy implications from the findings of this study.

1.3 Scope of the Study

After economic reforms, India became one of the fastest growing economies in the world. The government evolved liberal policy towards FDI and gives some incentives in term of tax exemption to embrace sufficient level of foreign investment. This study is expected to throw light on whether government decision to allow FDI is good or need some regulation over it.

1.4 Limitation of the Study

The present study is based on aggregate data consisting of yearly and quarterly observations and hence will not capture the micro level impact of the variables. We are also unable to model the effect of economic reforms (which was initiated in 1991) due to rather short time-series data. Apart from DI, FDI and openness, there can be a number of variables such as education, and inflation etc drive the economic growth of a country.The present analysis is, however, confined to the role of FDI, DI and openness only in economic growth.

1.5 Organization of the Study

The contents of the present study on “Foreign Direct investment and Economic Growth in India” have been organized into six chapters: the first chapter presents a brief introduction focusing onstatement of the problem, objectives of the study, scope and limitations of the study. The second chapter presents a brief review of literature so as to point out the theoretical and empirical gaps if any, with the purpose of putting the present work in right prospective. The third chapter deals with the evolution of government policy towards FDI, composition of FDI, FDI caps on different sectors, country-wise distribution of FDI and sector-wise distribution of FDI. The fourth chapter describes the theoretical framework consisting of time series econometric techniques such as unit root tests, co-integration tests and vector error correction method and data source and description. While empirical results based on the annual and quarterly sets of observations have been presented in chapter fifth. Finally chapter six contains conclusion and policy suggestions.