Chapter: 1
Introduction and Background of Study

1.0 Definition and Meaning of FDI

Foreign Direct Investment has played an important role in the process of globalization during the last two decades. The rapid expansion in Foreign Direct Investment (FDI) by multinational enterprises may be attributed to significant changes in technologies, greater liberalization of trade, investment regimes,and privatization of markets in many countries including developing countries like India. Stronger positive relationship exists between FDI inflow, and domestic saving and growth (Chung Chen, et al.1995). There is no specific definition of FDI owing to presence of many authorities like the IMF, OECD, IBRD and RBI. All these bodies have attempted to illustrate the nature of FDI with certain measuring methodologies. The key feature that distinguishes FDI from other capital flows is the intention to exercise control over a firm or institution.

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 on another economy*."[i]

Foreign Direct Investment is a category of investment that reflects the objective of establishing a lasting interest by resident enterprise in one economy (direct investor). That is resident (direct investment enterprise) of an economy other than that of the direct investor. The lasting interest implies the existence of a long-term relationship between the direct investor and the direct investment enterprise, and significant degree of influence on the management of the enterprise.

Trade in goods and services do not exist as a factor of production such as labour and capital were not internationally traded. In recent times, however, international labour 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 labour have perhaps become most traded factors of production now the days.

Resource-seeking FDI is motivated by the availability of natural resources, for example minerals, raw material and agricultural products in host countries[ii]. Market-seeking FDI in developing countries shows the size and growth of host-country markets where these are among the most important FDI determinants. Efficiency-seeking FDI is motivated by creating new sources of competitiveness for firms and strengthening the existing ones, the intention of difference in cultures and institutional arrangements and economic system.[iii] Accordingly, the competition for FDI would be based increasingly on cost difference between locations, the quality of infrastructure and business-related services, the ease of doing business and availability of skills.

Foreign Direct Investment (FDI) flows are usually preferred over other forms of external finance. Because they are non-debt creating, non-volatile and their returns depend on the performance of the projects financed by the investors. FDI also facilitates International trade and transfer of knowledge, skills and technology.

The world economy welcomes FDI with FDI favorable policy. Moreover, trade policy is also becoming more flexible by evading tariffs and trade barriers. The FDI efficiency in promoting growth also depends on trade policy. Most of the countries have liberalized their economies, reformed their institutions and improved infrastructure facilities to attract more FDI inflows. India 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; intensify the quality of products through infusion of modern technology to make the product tradable at international market. Therefore, it becomes a source of foreign exchange earnings through promoting exports.USA was most attractive destination for FDI during 1988-89. During this period the position of India in largest host economies was negligible. In 2011, India ranked 13th with US$26 billion as host economy. In 2012, India ranked 14th with the inflow of US$25.5 billion. India recorded negative growth of FDI inflow during 2011 and 2012. USA, China is still on the top most attractive countries as host economy. India was the world's 3rd most attractive destination for investment by transnational corporations in 2013. Global FDI flows were US$199.3 billion in 1991. Global FDI flows rose by 11% in 2013 to an estimated US$1.46 trillion, up from a revised US$1.32 trillion in 2012. FDI inflow increased in all major economic groups-developed, developing and transition economics[iv]. Besides in India in 1991 total FDI inflows were US$155 million[v] which was less than 1(0.07) per cent of Global FDI. In 2013, India received US$ 28 billion[vi] which is 1.91 percent of Global FDI and it is a positive sign. Though, this is the turtle speedof FDI inflow but consequently, India has registered significant growth rate in post reform period.

1.2 FDI and Macroeconomic Variables

Macroeconomics is the branch of economics that studies the behavior and performance of an economy as a whole. It focuses on the factors which include level of employment, unemployment, gross national product, balance of payments components, and price. Macroeconomic also covers role of fiscal and monetary policies, economic growth, and determination of consumption and investment level.

Mostly, models and theories are generated on trade conditions with comparative analysis. Vast literature on the determinants of FDI in developing countries clearly indicates the importance of infrastructure, skills, macroeconomic stability and sound institutions to attract the FDI inflows. There are merely few studies found which explain the relationship betweenmacro variables of host country and foreign direct investment. The casual relationship between FDI and macro variables has been pointed out by many researchers.E.Borenszteinet al. (1997) found that the FDI has a positive overall effect on economic growth and domestic Investment;Magnus Blomstrom et al. (1997)has shown that the employment was associated with foreign production mainly among manual labour; Dua Pamiet al. (1998) found the causal relationship between economic activity and actual flows of FDI which affect output; Riccardo Faini et al. (1999) investigated that Italy imports jobs through trade and exports them through foreign direct investment;Kohli Renu (2001) concluded that the Capital flows financed more investment than consumption, current account deficit widened in correspondence with capital surge and capital flows are associated with real appreciation. Kevin Honglin Zhang (2001) investigated long run FDI-GDP links exists with unidirectional and bidirectional relationship;Elizabeth Asiedu (2002), found that trade openness also promotes FDI; David Deok et al. (2003), found that FDI does not crowd out domestic investment; David Deok-Ki Kim et al. (2003), investigated that FDI shows strong dynamic endogeneity to domestic macroeconomic conditions and FDI crowds out Domestic Investment; Faiza Saleem et al. (2013),Positive relationship exists between foreign direct investment and inflation and there exists a negative relationship between gross domestic product and foreign direct investment; Jason Kiat (2007), Inflation was a negative impact on FDI, while the effect of exchange rate was debated with FDI; W. Jos Jansen et al. (2014),Found that more synchronized business cycles were associated with stronger FDI relations in the period 1995 to 2011, but not before 1995; James B. Ang (2009), Causality test found the bidirectional relationship between FDI and output growth. FDI and output are positively related in the long-run and Muhammad Shahzad Iqbal, et al. (2010),Bidirectional causality found between FDI and GDP, FDI and export, GDP and export, and import and export.

1.3Government Policiestowards FDI

India's policy towards FDI has gone through a number of phases. The government has initiated several policy measures to regulate FDI inflow. Though the chronological development of FDI policy over time is not strictly separable but it is convenient to divide the overall period into pre-liberalization and post -liberalization:[vii]

1.3.0Pre liberalization

After independence, India adopted the strategy of import substitution[viii]policy in the framework of development.During the industrialisation era import substation strategy highly focused on development of capability domestic firms.Therefore, foreign investors were allowed to fulfil the shortage of domestic capital as well as for technology assistance. They were assured of no restrictions on the remittances of profits and dividends, fair compensation in the event of acquisition.[ix] However, it was provided that, as a rule, the major interest in ownership and effective control would always be in Indian hands. While foreign exchange crisis developed towards the end of 1950s, FDI policy was further liberalised and offered incentives and concessions to the foreign investors. The government issued a list of industries in 1961 taking into account the gaps in capacity in relation to plan targets where foreign investments were to be welcomed. These included some of the industries earlier reserved for the public sector, such as drugs, aluminium, heavy electrical equipment, fertilizers and synthetic rubber.[x]

FDI concentrated on raw materials, service sector, tea plantation and jute industry. Over a quarter of first phase period, total FDI was contributing half of India's exports; about 32 percent in trading and other service, 9 percent in petroleum and only 2 percent in manufacturing other than jute[xi].The government policy was more restrictive towards FDI in late 1960s to protect the interest of domestic firms. Indian economy was following import substitution policy till mid 1970s and imposed restriction on foreign investment to protect the domestic investors.

The domestic firms especially infant industries were inefficient to compete at international level and needed protection from foreign firms, a more precise policy towards FDI was adopted with below given features:

(a) Restrictions were imposedon FDI proposal without technical collaboration and those seeking more than 40 percent foreign ownership.

(b) Only technical collaboration requiring exclusive of Indian consultancy service were available.

(c) The renewals of foreign collaboration agreements were restricted.

(d) The government listed industries in which FDI was not considered desirable in view of availability of local capabilities.

Moreover, Foreign Exchange Regulating Act (FERA) of 1973 required all foreign companies operating in India to register under Indian corporate legislation with up to 40 percent foreign equity. Exceptions from the general limit of 40 percent were made only for companies operating in high priority or high technology sectors, tea plantations, or those producing predominantly for exports. It became the key to guiding and controlling FDI. The phase of tight regulation and selective policy was implemented by an administrative system based on discretionary power.

Towards the end of the 1970s, India's export-oriented firms were suffering in wake of second oil price shock, which further, deteriorated the foreign exchange position of India. Another problem for India's manufactured exports was that marketing channels in the industrialized countries substantially dominated by MNCs. In comparison to them India's products were inferior. Since Indian goods were suffering from technological obsolescence, it evoked the government to change its attitude towards FDI. Therefore, it adopted more liberal attitude towards FDI and permitted to import technology and capital goods. However, after first oil shock, government adopted restrictive policy towards foreign investment, but after second oil shock, government policy was more favorable for FDI rather than to limiting it. The liberalization policy of 1980 and 1982 was an incentive for the foreign investor especially giving exception to foreign equity from FERA to 100 percent export oriented units. In addition, it was also decided to set up Export Processing Zone (EPZ) with the intention of increasing quantum of exports. During the period 1984-1985, 150 items and 200 types of capital goods were added to Open General License (OGL) list. Moreover, liberalization of industrial and trade policies was accompanied by an increasingly receptive attitude towards FDIs and foreign licensing collaborations.

1.3.1 Post Liberalization

There has been a paradigm shift in policies towards FDI with the adoption of industrial policy in 1991. One of the objectives of Industrial Policy was that foreign investment and technology collaboration will be welcomed to obtain higher technology; to increase exports as well as productivity capacity. The Industrial policy followed an open door policy on foreign investment and technology transfer. The new Industrial Policy market a major departure with respect to FDI policy with the abolition of industrial licensing system except where it is required for strategic or environmental ground, creation of a system of automatic clearance of FDI proposals fulfilling the conditions laid down, such as the ownership level of 50 percent, 51 percent,, 74 percent and 100 percent foreign equity and opening of new sectors such as mining, banking, insurance, telecommunication, construction and management of ports, harbours, roads and highways, airlines, and defence equipments to foreign-owned companies subject to sectoral caps. The policy since then has been aimed at encouraging foreign investment particularly in core and infrastructure sectors. During this phase, favorable policy environment on the foreign investment, foreign technology collaboration, foreign trade and foreign exchange have been exerting positive influence on foreign firms decision on investment.

In 1999, FERA was replaced by Foreign Exchange Management Act. Government has permitted access to the automatic route for FDI, except a small list of sectors (detail given below). Moreover, companies with more than 40 percent of foreign equity are now treated at par with fully Indian owned company. New sectors such as mining, banking, telecommunications, highways, constructions, airports, hotels &tourism, courier and management has been opened for foreign investors. Even the defense industry sector opened up to 100 percent for Indian private investors with 26 percent FDI. In 2012, India allowed FDI in multi-brand retail and in civil aviation; Sectoral caps were revised upwards in 2013 in some sectors like telecom to 100 percent, in insurance to 49 percent, and in defence equipment beyond 26 percent on a case by case basis. In 2013, FII investments were reclassified as FPI which is subject to their holding in a company within 10 percent of its equity. Any holding beyond 10 percent will qualify as FDI[xii].

The inflow of FDI is reported under five broad heads such as,

(a) Reserve Bank of India's approval route for equity holdings up to 51 percent,

(b)Foreign Investment Boards' discretionary approval route for large projects with equity holding greater than 51 percent,

(c) Acquisition and approval route which is considered as a part of FDI since 1996,

(d) RBI's non residential Indian (NRI schemes)

(e) External commercial borrowings through ADRs and GDRs route;

1.4Statement of the problem

To the best of my knowledge few studies are found that explain the causal relationship of different macroeconomicvariables of host country with foreign direct investment.James B. Ang (2009) found bidirectional relationship between FDI and output growth, FDI and output are positively related in the long-run. Muhammad Shahzad Iqbal et al. (2010)bidirectional causality found between FDI and GDP, FDI and export, GDP and export, and import and export. Casual relationship investigated between FDI and growth by many authors. Khan Gholam Syedain(2014),has not found causality between FDI and inflation in India. Contradictory, Tripathi Vanita et al (2012), found that the inflation granger caused by FDI inflow in case of India.Shu-Chen Chang (2006) has not found any significant association between unemployment and inflow of FDI. So there is need to investigate the casual relationship between FDI and macro variables with the help of this work. The proponents of FDI argue that FDI helps to promote economic growth through fluctuation in difference macro variables.Dua Pami et al. (1998) suggested that FDI have a positive effect on the economy.Despite amount of literature on the study, the relation of FDI with macro variables remains highly controversial due to wide variations lies among the countries with respect to the nature and availability of data, which make a cross-country comparison a risky business. Jong Il Choe (2003)said that it not necessary by the result of causality that the high FDI inflows or GDI rates lead to economic growth. The Impact of FDI and GDI on economic growth may differ among individual countries.Moreover, the policy towards FDI differs from country to country. India has adopted not only liberal attitude towards FDI but also giving much incentives to the foreign investors. In post liberalization period, India is achieving a significant economic growth in different macro variables. This raises an important question whether the government's policy towards FDI should continue in the interest of macroeconomic variables. Moreover, it needs to be examined whether FDI has causal relationship with the macro variables. This study included the addition of different endogenous and exogenous macroeconomic variables to investigate the causal relationship with FDI inflow. Based on the above considerations, this study framed these objectives.

1.5Objectives of the study

This study has the following objectives:

1. To analyse the trends and behavior of FDI inflow and macroeconomic variables since 1991.
2. To estimate the short run and long run relationship between FDI inflow and macroeconomic variables in India.
3. To analyse the causal relationship between FDI inflow and endogenous macroeconomic variables.
4. To analyse the causal relationship between FDI inflow and exogenous macroeconomic variables.
5. To suggest the policies implications of study.

1.6Hypothesis of the study

H_o :FDI inflow does not cause inflation, unemployment and gap of growth output.

H_o : FDI inflow does not cause development expenditure and non-development expenditure.

H_o : FDI inflow does not cause gross fixed capital formation and gross domestic saving.

H_o : FDI inflow does not cause foreign reserve, annual exchange rate and trade openness.

H_o : FDI inflow does not cause net external assistance, net commercial borrowing, rupees debt services and net NRI deposits.

1.7Scope 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 government decision to allow FDI to go in right direction and achieve the targeted growth of aggregate variables.

1.8 Organization of the Study

The content of the present study on "FDI and Macro Variables in India: A Study of Bidirectional Relationship" have been organized into six chapters:

Chapter 1: Introduction and Background of the study focusing on the definition of variables, profile of FDI in India, statement of the problem, objectives of the study and hypothesis of the study.

Chapter 2: Review of literature: presents a deepanalysis to point out the theoretical and empirical gaps if any, with the purpose of putting the present work in right prospective.

Chapter 3: Methodology: describes the methodology consisting of time series econometric techniques such as unit root tests, co-integration tests and vector error correction method and data source and description.

Chapter 4:This chapter describes the trends and behavior of Foreign Direct Investment inflow and macroeconomic variables.

Chapter 5: This chapter is based on econometrics methods to investigate the causal relationship between FDI & endogenous macroeconomic variables

Chapter 6:This chapter is also based on econometrics methods to investigate the causal relationship between FDI & exogenous macroeconomic variables

Chapter 7:Conclusion, policy suggestion, limitation and future perspective.

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[i] International Monetary Fund, 2004

[ii] Reserve Bank of India, Reports and Publications

[iii] World Investment Reports

[iv] UNCTAD Reports and Publications

[v] World Investment Report

[vi] UNCTAD Report ,2013

[vii] This has been classified as mentioned by Uma Kapila, (2009) and Nagesh Kumar, (1995).

[viii] The import substitution policy is that almost everything that could be manufactured in the country itself.

[ix] Nagesh Kumar, N. (2005), p. 1459.

[x] Nagesh Kumar. (1995), p. 5.

[xi] M. Kidorn,.(1965), p. 30.

[xii] Reserve Bank of India, Reports and Publications