

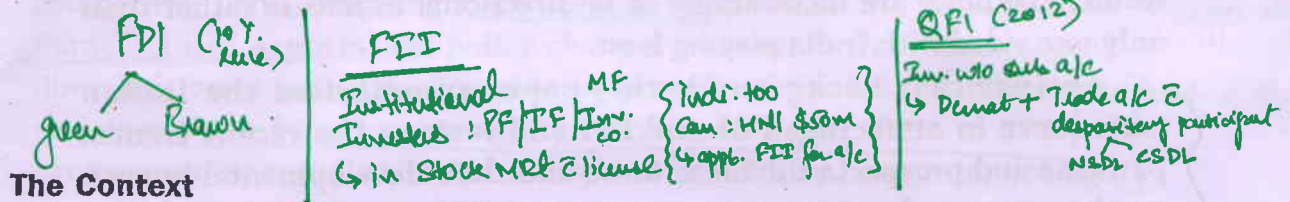
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Foreign Direct and Portfolio Investments Flows and Development

$$FII + QFI = FPI$$

A Perspective on Indian Experience



Foreign capital flows have emerged as key channels of global economic integration all across the world over the past two decades. While foreign direct investment (FDI) flows have been undertaken for a long time by multinational enterprises (MNEs) in the course of their overseas expansion, foreign portfolio investments (FPIs) representing equity and debt flows unaccompanied by management control have become highly visible and often dominant components of the foreign capital flows in recent years with the rise of foreign institutional investors (FIIs) and sovereign wealth funds on the horizon that seek to make quick returns through short-term speculative activities abroad.

FDI flows represent longer-term investments made abroad bringing together with capital and entrepreneurship, technology and managerial know how and sometimes even market access, hence are seen by developing countries as catalysts of development. Therefore, most developing countries actively seek to attract FDI flows with different policy instruments. FPIs, in contrast, tend to have limited potential of contributing to development, if at all, given their short-term and speculative nature. Their distribution across countries is highly uneven as they target only the fast growing emerging economies and those with deep capital markets to benefit from their dynamism. In fact they are often seen to be bringing volatility to the financial and exchange rate

markets. Hence, a number of emerging market economies are seeking to moderate their volatility through a variety of capital controls.

Recent years have also seen the rise of FDI and FPI flows in India. This can be partly attributed to substantial liberalisation of the policy regime since 1991 and with her economy embarking on robust growth trajectory in the new millennium, India also begun to attract increasing attention of MNEs as well as FIIs as destination for investments. The past decade also marked the emergence of India as sources of outward investments. Indian enterprises have begun to use outward FDI as a strategic tool for strengthening their international competitiveness. As a result, FDI flows are increasingly of bi-directional in nature rather than only one sided with India playing host.

Against that background, this paper summarises the Indian experience in attracting FDI and FPI and reviews the recent trends, patterns and prospects for these flows and their developmental impact. As the country also emerges as a source of FDI as well, the paper also briefly touches upon the trends in these flows. It concludes with some policy lessons.

Evolution of Policy Regime Towards FDI and FPIs in India

Indian government policy towards FDI has evolved over time in tune with the requirements of the process of development in different phases (see Kumar, 2005a). Soon after Independence, India embarked on a strategy of import substituting industrialisation in the framework of development planning with a focus on encouraging and improving the local capability in heavy industries including the machinery-manufacturing sector. As the domestic base of 'created' assets viz., technology, skills, entrepreneurship was quite limited, the attitude towards FDI was increasingly receptive. FDI was sought on mutually advantageous terms, though the majority local ownership was preferred. The government adopted a more restrictive attitude towards FDI in the late 1960s as the local base of machinery manufacturing capability and local entrepreneurship developed and as the outflow on account of remittances of dividends, profits, royalties, and technical fees, etc. abroad on account of servicing of FDI and technology imports grew sharply. Restrictions were put on proposals of FDI's unaccompanied by technology transfer and those seeking more than 40 per cent foreign ownership. From 1973 onwards, the further activities of foreign companies (along with those of local large industrial houses) were

50s

ISI + Export
Performance↳ self reliance
↳ Initially on
natural resource
base

60s

↳ Restrictive

outflow of funds
↳Mandatory
tech.

transfer

(+40%)

Ownership

restricted to a select group of core or high priority industries. The Foreign Exchange Regulation Act (FERA) of 1973 required all foreign companies operating in India to register under Indian corporate legislation with up to 40 per cent foreign equity. Exceptions from the general limit of 40 per cent were made only for companies operating in high priority or high technology sectors, tea plantations or those producing predominantly for exports.

In the 1980s, the attitude towards FDI began to change as a part of the strategy of modernisation of industry with liberalised imports of capital goods and technology, exposing the Indian industry to foreign competition, and assigning a greater role to MNEs in the promotion of manufactured exports. The policy changes adopted in the 1980s covered liberalisation of industrial licensing (approval) rules, a host of incentives, and exemption from foreign equity restrictions under FERA to 100 per cent export-oriented units and a degree of flexibility concerning foreign ownership.

After pursuing a restrictive policy towards FDI over the four decades with a varying degree of selectivity, India changed tracks in 1990s and embarked on a broader process of reforms designed to increase her integration with the global economy. Among the reform measures implemented included a departure from the restrictive policy towards FDI, a much more liberal trade policy besides reforms of capital market and exchange controls. The New Industrial Policy (NIP), announced on 24 July 1991, marked a major departure with respect to FDI policy with the abolition of industrial licensing system except where it is required for strategic or environmental grounds, creation of a system of automatic clearance of FDI proposals fulfilling the conditions laid down, such as the ownership levels of 50 per cent, 51 per cent, 74 per cent and 100 per cent foreign equity, and opening of new sectors such as mining, banking, insurance, telecommunications, construction and management of ports, harbours, roads and highways, airlines, and defence equipment, to foreign-owned companies subject to sectoral caps: Foreign ownership up to 100 per cent is permitted in most manufacturing sectors—in some sectors even on automatic basis—except for defence equipment where it is limited to 26 per cent and for items reserved for production by small-scale industries where it is limited to 24 per cent. The dividend balancing and the related export obligation conditions on foreign investors, which applied to 22 consumer goods industries, were withdrawn in 2000 (Kumar, 2005a). In September 2012, India allowed FDI in multibrand

70s

Restrictions ↑

→ FERA.

→ selected areas of work.

80s

→ Renewal of policy

→ Bigger role to MNE

→ Advoc reform.

90s

LPG

→ licensing system abolished

→ FDI ← auto ↑ sectoral caps

Export obligations removed

Almost all
sectors 40%
automatic
route

retail and in civil aviation. Sectoral caps were revised upwards in July 2014 in some sectors like telecom to 100 per cent, in insurance to 49 per cent, and in defence equipment beyond 26 per cent on a case-by-case basis.

FII

In September 1992, the Indian government announced guidelines for investments by FIIs in the Indian capital market. FIIs were now welcome to invest in all types of securities traded on the primary and secondary market with full repatriation benefits and without restrictions on either volume of trading or lock-in period. This liberalisation has led to considerable inflows of portfolio inflows making the country one of the most exposed to portfolio inflows. In June 2013, FII investments were reclassified as FPI which is subject to their holding in a company within 10 per cent of its equity. Any holdings beyond 10 per cent will qualify as FDI.

FII > 10%
equity

→ FDI

Recognising the importance of outward investment for competitiveness of enterprises, the policy governing outward FDI has also been liberalised since 1991. With the build-up of foreign exchange reserves, the limits for outward investments have been gradually relaxed and Indian enterprises are now permitted to invest abroad up to 100 per cent of their net worth on automatic basis.

Outward
FDI
also
liberalised

India has also entered into 88 Double Taxation Avoidance Treaties, and Bilateral Investment Promotion and Protection Agreement (BIPAs) with 82 countries.

Foreign Direct Investment Flows and Their Quality

Trends in FDI Inflows

FDI inflows to India have been growing 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 increased from that level peaking to \$47 billion in 2008 before declining to \$27 billion in 2010 in the wake of the global financial crisis but recovering to \$36.5 billion in 2011 (Table 40.1A). With the slowdown of Indian economy since 2011, however, it declined again and was at \$28 billion in 2013. India's share in global FDI inflows nearly doubled over 2005-06 and again between 2006 and 2009 to nearly 2.9 per cent before declining to little 2.1 per cent in 2011 (Table 40.1, Figure 40.1A). The relative importance of the flows in relation to gross fixed investment has also risen from 2.9 per cent in 2005 to 6.6 per cent in 2006. The share of FDI in gross fixed investments

Share ~ 2%
Global FDI

FDI
GCF

Table 40.1

Inward Foreign Direct Investment Flows, Annual, 2001-2013

A. Inward FDI flows, annual 2001-2013, million USD														(Million US\$)
Year	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	
World	837748	628760	604303	737682	996714	1481561	2001987	1818834	1221840	1422255	1700082	1330273	1451965	
Developing Economies	226164	172323	197459	284619	341428	432869	591161	668758	532580	648208	724840	729449	778372	
Developing Economies: Asia	125212	99007	130810	170522	231822	296849	365822	396025	323683	409021	430622	415106	426355	
Southern Asia	6837	10568	8419	10875	14182	28590	34557	56692	42427	35038	44372	32442	35561	
India	5478	5630	4321	5778	7622	20328	25350	47139	35657	27431	36190	24196	28199	
Share of India in														
Developing Asia	4.4%	5.7%	3.3%	3.4%	3.3%	6.8%	6.9%	11.9%	11.0%	6.7%	8.4%	5.8%	6.6%	
Share of India in														
Developing Economies	2.4%	3.3%	2.2%	2.0%	2.2%	4.7%	4.3%	7.0%	6.7%	4.2%	5.0%	3.3%	3.6%	
Share of India in														
World	0.7%	0.9%	0.7%	0.8%	0.8%	1.4%	1.3%	2.6%	2.9%	1.9%	2.1%	1.8%	1.9%	

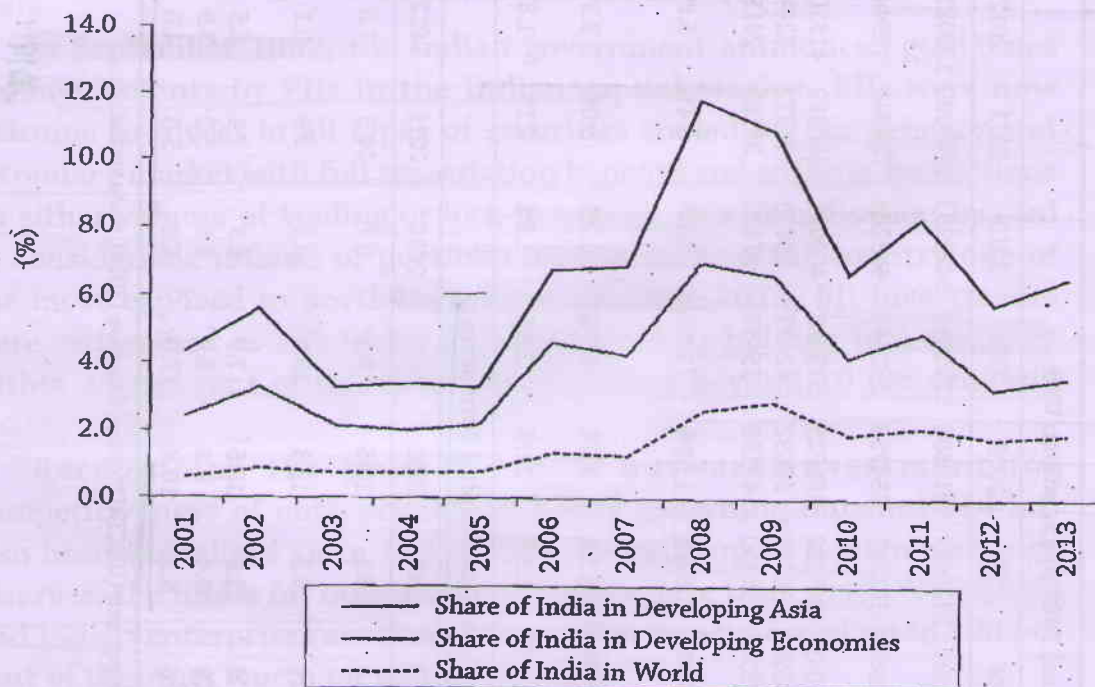
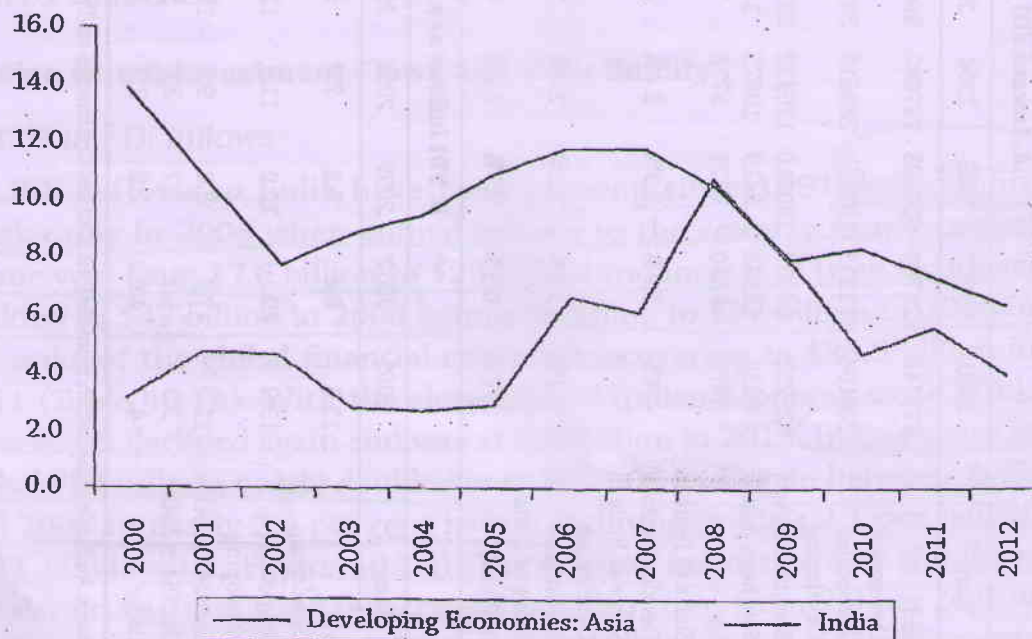
B. FDI Inflows as a per cent of Gross Fixed Capital Formation

Year	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
World	11.6	8.6	7.3	7.8	9.5	12.8	15.1	12.5	9.1	9.7	10.3	7.8
Developing Economies	13.8	10.1	10.0	11.9	12.1	12.9	14.3	13.3	10.1	10.2	9.8	9.1
Developing Economies: Asia	11.0	7.9	8.8	9.4	10.9	11.8	11.9	10.6	7.9	8.3	7.4	6.5
Southern Asia	3.9	5.5	3.7	3.6	3.9	6.8	6.4	9.4	6.9	4.6	5.2	3.9
India	4.7	4.6	2.8	2.7	2.9	6.6	6.2	10.8	7.9	4.8	5.6	4.0

Source: Author's compilation from United Nations Conference on Trade and Development (UNCTAD) online data base (2014), www.unctad.org.

2019: 2.5% of GDP → FDI/GDP

Figure 40.1

*India's Attractiveness as a Destination of FDI Inflows***A: India's Share in Global Inflows****B: Share of FDI in Gross Fixed Capital Formation in Developing Asian Economies and India**

Source: Author's calculations based on Table 30.1.

in India has been lower than for other developing countries but was catching up. In 2008 when FDI inflows peaked in India, this ratio at 10.8 per cent was quite close to that for developing Asia at 10.6 per cent. Afterwards it has declined in the wake of financial crisis indicating the potential for a rise in the future (Table 40.1B and Figure 40.1B)

Investment Climate and Prospects for FDI Inflows

The empirical studies of determinants of FDI inflows have found an important role of market size, extent of urbanisation, quality of infrastructure, geographical and cultural proximity with major sources of capital, and policy factors, e.g., tax rates, investment incentives, performance requirements, among other factors (Kumar, 2000). In the light of these findings, while India's large population base may be an advantage, relatively low income levels, low levels of urbanisation and relatively poor quality of infrastructure are disadvantages. Furthermore, India also does not have the benefit of geographical and cultural proximity with major sources of FDI such as the US, Europe or Japan. However, over time the relative attractiveness of the country is improving with rapid growth that is expanding market size and other aspects of macroeconomic performance. A recent inter-temporal analysis for India has found a broad correspondence between the industrial growth rates in a year and FDI inflows received in the following year (Kumar, 2005a). Apparently, good industrial performance tends to crowd-in FDI inflows as well.

MS, Urban, infra, policy, capital

The recent rise in FDI inflows since 2006 reflects improving investment climate in India with the acceleration of growth rate since 2003, the rise of a sizeable middle class with purchasing power, and with the recognition of India's comparative advantage in knowledge-based industries. This is not only evident from the rising magnitudes of FDI inflows but also from investor surveys conducted by global consultancy organisations. In the FDI Confidence Index published by AT Kearney, a global consultancy organisation, covering 25 top destinations for FDI, India has moved up from 6th place in 2003 to 2nd in 2005 and stayed there before swapping the 3rd rank with the US in 2010 (Table 40.2). In 2012, it again regained the second position in the global rankings (AT Kearney, 2012). In 2013, India moved down to the 5th rank globally as the US moved up to the 1st rank as the prospects for growth improved and as their natural resources bases helped Brazil (3) and Canada (4) moved up. Among the Asian developing countries, India continues to remain 2nd

Consistently top 10 recipients of FDI UNCTAD

after China. Similar upgrading in India's ranks has been reported by the surveys of investors conducted by the Japanese Bank of International Cooperation (JBIC) as well as in UNCTAD's *World Prospects Survey 2013-2015*, where India is ranked as the 3rd most preferred FDI location (UNCTAD, 2014). Recent reforms adopted by the country to allow FDI in multibrand retail and civil aviation and large infrastructure projects such as Delhi-Mumbai Industrial Corridor are also likely to help in realising its potential for FDI inflows. This is in sharp contrast to the World Bank's studies on Ease of Doing Business based on perception surveys that tend to put India at a very poor rank of 132. It is clear therefore that foreign investors get attracted to a country by the potential of benefiting from its dynamism and are willing to put up with hardships rather than going to countries with easier business conditions but with poorer prospects of making profits. FDI inflows may also assist in manufacturing-oriented structural transformation of the economy and technological upgrading of exports that India needs by bringing technologies and other resources working together with local entrepreneurs.

Table 40.2

Select Asian Ranking in FDI Confidence Index

	2003	2004	2005	2007	2010	2013
China	1 (1.97)	1 (2.03)	1 (2.19)	1 (2.21)	1 (1.93)	2 (2.02)
India	6 (1.04)	3 (1.4)	2 (1.95)	2 (2.09)	3 (1.64)	5 (1.85)
Thailand	16 (0.83)	20 (0.87)	20 (1.05)	17 (1.63)
Singapore	28 (0.91)	18 (1.07)	18 (1.75)	7 (1.19)	24 (1.77)	10
Malaysia	23 (0.67)	15 (0.92)	..	16 (1.63)	21 (1.22)	25 (1.60)
Hong Kong	22 (0.69)	8 (0.99)	10 (1.21)	5 (1.78)	14 (1.28)	..

Note: Index values are in parentheses.

Source: Author's calculation based on AT Kearney, Foreign Direct Investment Confidence Index, different years.

Quality of FDI Inflows

There can be several indicators of quality of FDI inflows (see Kumar, 2002). In what follows, we discuss India's performance in terms of a few such indicators.

1 Sectoral Composition

One of the indicators of quality is the sectoral composition of FDI inflows. It matters whether FDI is going to the modern technology-intensive sectors and building productive capabilities or to conventional sectors crowding out domestic investments. In terms of the sectoral composition of FDI inflows, there is a shift since 1991 in India's case. Earlier the bulk of FDI inflows used to be directed to manufacturing especially the high technology industries through a selective policy. After the liberalisation, a substantial proportion of FDI inflows has been directed to services. Manufacturing has accounted for only about 40 per cent of inflows in the post-1991 period with services accounting for about 35 per cent share. Furthermore, among the manufacturing subsectors, FDI stock in the post-1991 period is also more evenly distributed between food and beverages, transport equipment, metals and metal products, electricals and electronics, chemicals and allied products, and miscellaneous manufacturing. This stands in contrast to the situation prior to 1990 when there was a very heavy concentration in relatively technology-intensive sectors viz., machinery, chemicals, electricals, and transport equipment (Kumar, 2005a).

In China, on the other hand, the bulk of FDI inflows have been directed by the government policy to manufacturing (of the export-oriented type) and very little has gone to services (Yongding, 2006). Of the FDI in manufacturing in China, 11 per cent has gone in electronics and telecommunication equipment helping it emerge as the leading producer and exporter of these products. A policy guiding FDI inflows to manufacturing has helped in China's emergence as a global factory. Therefore, FDI inflows in China have been directed to assist in industrial development of the industry that has made China a global factory, generating in the process billions of dollars of output and exports and millions of jobs.

2 Impact of FDI 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. However, high growth rates may also attract more FDI inflows by enhancing the investment climate in the country. Therefore, the FDI-growth relationship is subject to causality bias given the possibility of two-way relationship. What is the nature of the relationship in India? A recent study has examined the direction of causation between FDI and growth

Sectoral Composition

Pre 1991 → High tech
Post 91 → Service sectors

Distortion b/w Mfg was shifted from tech intensive to Consumer & I.E.s.

11% to electronics in China.

global factory

FDI → growth
growth → FDI
→ Neutral for India (causation)

empirically for a sample of 107 countries for the 1980s and 1990s period. In the case of India, the study finds a Granger neutral relationship as the direction of causation was not pronounced (see Kumar and Pradhan, 2005, for more details of the methodology and results).

FDI may also be lead to immiserizing
→ crowd out
eg Ban on MNC

It has also been shown that sometimes FDI projects may actually crowd-out or substitute domestic investments from the product or capital markets with the market power of their well-known brand names and other resources and may thus be immiserizing (see Fry, 1992; Agosin and Mayer, 2000, for evidence). Therefore, it is important to examine the impact of FDI on domestic investment to evaluate the impact of FDI on growth and welfare in the host economy. An earlier study to examine the effect of FDI on domestic investment in a dynamic setting, however, did not find a statistically significant effect of FDI on domestic investment in the case of India (see Kumar and Pradhan, 2005). It appears, therefore, that FDI inflows received by India have been of mixed type combining some inflows crowding-in domestic investments while others crowding them out, with no predominant pattern emerging in the case of India. In the case of East Asian countries such as South Korea and Thailand, the relationship was clearly indicating FDI crowding-in domestic investments (Ibid.). Therefore, the quality of FDI in India in respect to its impact on growth and on domestic investment is of mixed type and leaves scope for improvement.

FDI inflows in India have been mixed

CO
CI
worse than of
EAC → + time
[CPI]

Some countries have used policies to vertically integrate MNE & domestic industry

→ LCRs
→ Auto - mobile

The empirical studies on the nature of the relationship between FDI and domestic investments suggest that the effect of FDI on domestic investment depends on host government policies. Governments have extensively employed selective policies and imposed various performance requirements such as local content requirements (LCRs) to deepen the commitment of MNEs to the host economy. The Indian government had imposed a condition of phased manufacturing programmes (or LCRs) in the auto industry to promote vertical inter-firm linkages and encourage development of the auto component industry (and crowding-in of domestic investments). A case study of the auto industry where such a policy was followed shows that these policies (in combination with other performance requirements viz., foreign exchange neutrality) have succeeded in building an internationally competitive vertically integrated auto sector in the country (Ibid.). The Indian experience in this industry, therefore, is in tune with the experiences of Thailand, Brazil and Mexico as documented by Moran (1998).

FDI and Export-platform Production

A number of developing countries have used FDI to exploit the resources of MNEs such as globally recognised brand names, best practice technology or by increasing integration with their global production networks, among others, for expanding their manufactured exports. In this respect, China has had a considerable success in exploiting the potential of FDI for export-oriented production. A very substantial (55%) proportion of manufactured exports of China are undertaken by foreign invested enterprises, which account for as much as 80 per cent of all technology-intensive exports (UNCTAD, 2005). Foreign enterprises while setting up export-oriented production bases created 23 million jobs by 2003 making China a global factory. Export-oriented FDI also helps in bringing world's best practice technology as the affiliate has to compete globally right from the beginning. It also enhances the chances of FDI inflows crowding in domestic investments and reducing the chances of crowd-out as the foreign affiliate would be mainly catering to the outside markets rather than eating into domestic firms' markets. It would also create fresh possibilities of market information spillovers for domestic firms on export possibilities.

Unlike the East Asian countries, India has not been able to exploit the potential of FDI for export-oriented production. The bulk of FDI inflows in India are market-seeking coming for tapping the domestic market with the share of foreign affiliates in exports around 10 per cent. Therefore, the quality of FDI in respect of export orientation is poorer compared to FDI received by East Asian countries. In this respect, two observations can be made. The first is that recent studies of export performance are beginning to indicate a relatively superior performance of foreign enterprises in terms of export orientation compared to early studies suggesting a poorer performance of foreign companies (see Kumar and Joseph, 2007). Therefore, MNEs are beginning to exploit the potential of India as base for export-oriented production.

The second observation is about the role of host country policies in exploiting the potential of FDI for export-oriented production. A quantitative study analysing the determinants of the patterns of export orientation of MNE affiliates across 74 countries in seven branches of industry over three points of time has shown that in host countries with large domestic markets, the export obligations were effective for promoting export orientation of foreign affiliates to third countries (see Kumar, 1998).

MNEs

- ↳ Brand
- ↳ Best Practice
- ↳ Quality
- ↳ GPN
- ↓
- own Mfg. opt.

Foreign enter-
prise % of mfg. %

X outward FDI

- ↳ GVCs
- ↳ AEP

crowd in

Share of
foreign enter-
prise % > 10%

* obligations eg China \Rightarrow MNE use them as leverage for Xs.

Export obligations have also been employed fruitfully by many countries to prompt MNE affiliates to exploit the host country's potential for export platform production. For instance, in China which has succeeded in expanding manufactured exports with help of MNE affiliates, regulations stipulate that wholly owned foreign enterprises must undertake to export more than 50 per cent of their output (Rosen, 1999: 63-71). As a result of these policies, the proportion of foreign enterprises in manufactured exports has steadily increased to over 55 per cent as observed above.

India has not imposed export obligations on MNE affiliates except for those entering the products reserved for SMEs. However, indirect export obligations in the form of dividend balancing have been imposed for enterprises producing primarily consumer goods (since phased out in 2000). Under these policies, a foreign enterprise was obliged to earn the foreign exchange that it wished to remit abroad as dividend so that there was no adverse impact on host country's balance of payment (BoP). Sometimes a condition of foreign exchange neutrality has been imposed where the enterprise is required to earn foreign exchange enough to even cover the outgo on account of imports. Therefore, these regulations have acted as indirect export obligations prompting foreign enterprises to export to earn the foreign exchange required by them. The evidence that is available suggests that such regulations have prompted foreign enterprises to undertake exports. In the case of auto industry, in order to comply with their export commitments to comply with foreign exchange neutrality condition, foreign auto majors have undertaken export of auto components from India which have not only opened new opportunities for Indian component manufacturers but also in that process found profitable opportunities for business (Kumar, 2005). Hence, exports of auto components from India are now growing rapidly and exceeding the obligations several times over. These regulations have acted to remove the information asymmetry existing about the availability of quality components in India among the foreign auto majors. In that respect, India's experience is very similar to that of Thailand that has emerged as the major auto hub of Southeast Asia (as documented by Moran, 1998, and Kumar, 2005).

R&D and Other Knowledge-based Activities and Local Technological Capability

A comparison of R&D (research & development) intensity of foreign firms in India and in other countries has not been possible due to lack of

data. Within the country, foreign firms appear to be spending more on R&D activity in India than local firms, although gap between their R&D intensities has tended to narrow down. A study analysing the R&D activity of Indian manufacturing enterprises in the context of liberalisation has found that after controlling for extraneous factors, MNE affiliates reveal a lower R&D intensity compared to local firms, presumably on account of their captive access to the laboratories of their parents and associated companies. The study also observed differences in the nature or motivation of R&D activity of foreign and local firms. Local firms seem to be directing their R&D activity towards absorption of imported knowledge and to provide a backup to their outward expansion. MNE affiliates, on the other hand, focus on customisation of their parents' technology for the local market (Kumar and Agarwal, 2005).

An important issue is diffusion and absorption of technology brought by foreign firms in the host countries. Some governments have imposed technology transfer requirements on foreign enterprises, e.g., Malaysia. However, such performance requirements do not appear to have been very successful in achieving their objectives (UNCTAD, 2003). Instead, other performance requirements such as local content requirements or domestic equity requirements may be more effective in transfer of technology. As observed above, local content requirements and export performance requirements have prompted foreign enterprises to transfer and diffuse some knowledge to domestic enterprises in order to comply with their obligations. Similarly, the domestic equity requirements may facilitate the quick absorption of the knowledge brought in by foreign enterprises which is an important pre-requisite of the local technological capability, as is evident from case studies of Indian two-wheeler industry where Indian joint ventures with foreign firms were able to absorb knowledge brought in by the foreign partner and eventually become self-reliant not only to continue production but even to develop their own world-class models for domestic market and exports on their own (see Kumar, 2005). Some have expressed the view that domestic equity requirements may adversely affect the extent or quality of technology transfer (Moran, 2001). However, it has been shown that MNEs may not transfer key technologies even to their wholly owned subsidiaries abroad fearing the risk of dissipation or diffusion through mobility of employees. Furthermore, even if the content and quality of technology transfer is superior in the case of a sole venture than in the case of a joint venture, from the host country point of view, the latter may have

Tech. transfer
e.g. Volvo not
whisked instead
↳ x requirement
↳ LCR.
↳ local equity

eg Hero - Honda
Maruti - Suzuki

more desirable externalities in terms of local learning and diffusion of the knowledge transferred.

FPI Inflows and Their Impact

The rapid rise in inflows of portfolio investments in India since 2003-04 is summarised in Table 40.3. Large magnitudes of portfolio investments in the form of short-term equity investments by FII have flowed in as the Indian economy gathered momentum and capital markets started giving attractive returns. The annual net inflows, however, are highly volatile.

Table 40.3

FDI and Foreign Portfolio Investment Flows to India

	Gross Inflows/ Gross Investments	Direct Investment to India	FDI by India	Net FDI	Net Portfolio Investment	Total (in million USD)
2000-01	4029	4029	759	3270	2590	5860
2001-02	6130	6125	1391	4734	1952	6686
2002-03	5035	4976	1819	3157	944	4101
2003-04	4322	4322	1934	2388	11377	13765
2004-05	6051	5986	2274	3712	9291	13003
2005-06	8961	8900	5867	3033	12492	15525
2006-07	22826	22739	15046	7693	6947	14640
2007-08	34843	34727	18836	15891	27434	43325
2008-09	41873	41707	19364	22343	-14032	8311
2009-10	37745	33108	15143	17965	32396	50361
2010-11	34847	27829	16524	11305	30292	41597
2011-12	46556	32957	11097	22860	17171	39031
2012-13	34298	26953	7134	19819	26891	46710

Source: Extracted from RBI's Handbook of Statistics on Indian Economy, 2013, and www.rbi.org.in.

FII inflows rose to a sizeable \$27 billion in 2007-08 that led to not only stock prices booming, with BSE Sensex more than doubling from under 10,000 to 20,000, but also the rupee exchange rate appreciating sharply from ₹ 47 in 2006 to ₹ 38 to a US dollar in 2008. In 2008-09, in the wake of global financial crisis, there was a net outflow of FII to the tune of \$14 billion that brought down the BSE Sensex from nearly 20,000 points to less than 9,000 points in the early part of 2009. Much

more importantly it led to a sharp depreciation of rupee by nearly 25 per cent in early 2009. The depreciation would have been greater had the Reserve Bank of India (RBI) not intervened in the market by selling dollars. This depleted the RBI's foreign exchange reserves by \$58 billion to about \$252 billion from \$310 billion from 2007-08 to 2008-09. However, as FII's returned quickly to the market in the wake of recovery, the FII inflows to the country in 2010 were of the order of \$32 billion bringing the Sensex back above 20,000 points in October 2010. Despite the RBI's market intervention to offset the subsequent exchange rate pressure, the rupee appreciated by nearly 8 per cent, although foreign exchange reserves were augmented to about \$284 billion. FII inflows have become primary determinants of the movements in the stock exchange indices and the exchange rate of the rupee (see Kumar, 2011). As there are sharp movements in these inflows linked to global developments, they become channels of transmission of instability to the country's financial system. As a result, the rupee has been on a roller coaster ride: from ₹ 44 per dollar in January 2007 to ₹ 39 in January 2008 to increase again to ₹ 49 per dollar in January 2009 to ₹ 44 in October 2010. The rupee fluctuated around ₹ 54 in 2012 and early 2013 and after May 2013 depreciated sharply to cross ₹ 60 to a dollar, as there was outflow of FIIs in anticipation of roll back of quantitative easing policy by Federal Reserve in the US and as concerns about India's rising current account deficit (CAD) mounted.

Besides the volatility, FII inflows have a very high servicing burden. Among foreign resources such as FDI, foreign borrowings, non-resident Indian (NRI) deposits, American Depositary Receipts (ADRs), global depositary receipts (GDRs), FII investments are most expensive in terms of servicing burden (Kumar, 2011). This is because they come to chase primarily good returns at the stock markets and exchange rate speculation. In 2007-08, Indian stock markets were giving around 44 per cent return. That means for every dollar India received in FII flows, it became liable to pay \$1.44 in one year. As they are stock price makers rather than takers, they manage to exit safely before major crashes of markets thereby precipitating the declines.

One may argue that FII inflows help a country to build foreign exchange reserves. What is not appreciated very well is the fact that exposure to these inflows also enhances the need to have large foreign exchange reserves due to their highly volatile nature. Therefore, developing countries such as India should rely for their foreign resource

see 2020

FII sold \$15 bn
in 2020 from
equity & debt
→ Net: 40 < 10 26

VIX index rose
500%

(Measure of market
volatility in which
expectations of future
stock market volatility
in near future
may be based upon)
→ 20 days ahead

$VIX \propto \frac{1}{\text{Stock Index}}$

Re volatility 70
86
→ Pans
return \$490 bn

needs more on FDI inflows and where possible raise ADRs/GDRs and deposits from NRIs rather than relying on the FIIs. In view of their high cost and their other deleterious effects such as volatility, a number of emerging economies such as Brazil, South Korea and Indonesia have recently imposed capital controls to moderate their volatility. The unprecedented injection of liquidity by the governments in developed countries in the wake of global financial crisis is likely to find its way to emerging economies of Asia like India to take advantage of higher returns. There is now a growing consensus on the relevance of capital controls as aspects of the policy-tool kit for the governments in emerging economies (UN-ESCAP, 2010; Ostry *et al.*, 2010). The benefits of maintaining open capital accounts, if any, are ambiguous.

India as an Emerging Source of FDI Outflows

Another important emerging trend with respect to FDI in India is its emergence as a significant source of FDI outflows. Like FDI inflows the major turnaround in their outflows came in 2006 when outflows more than quadrupled in one year to \$14 billion and peaked to nearly \$20 billion in 2007 before declining to around \$15 billion in subsequent years in the wake of global financial crisis (Table 40.4). The big break came with Indian enterprises using their outward investments to acquire larger companies in the advanced economies as a part of their effort to augment their bundles of strategic assets including known brand names, proprietary knowledge and global marketing networks in order to jump start their global orientation. The past few years have seen several multi-billion dollar acquisitions of western firms by Indian companies including Tata Steel-Corvus, Tata Motors-Jaguar/Land Rover, Handalco-Novelis, among others. During 2012 and 2013, outward FDI flows declined dramatically as Indian companies struggled with slowdown of Indian economy (Table 40.4).

A recent analysis of India's outward FDI flows has shown that among the emerging markets, the relative scale of India's outward FDI was quite significant (Kumar, 2008). The emergence of Indian enterprises on the global scene is striking considering their origin in a lower middle-income country. Their ability to acquire much larger enterprises in the developed world reflects their confidence in managing the newly acquired entities successfully. It has been argued that the source of their ownership or competitive advantage lies in their accumulation of skills for managing large multi-location operations across diverse cultures in India and in their

ability to deliver value for money with their 'frugal engineering skills' honed up while catering to the larger part of income pyramid in India (Ibid.).

Table 40.4

Foreign Direct Investment Outflows Originating in India

(Million USD)

	World	Developing Economies	Developing Economies: Asia	India
2001	747657	83087	49155	1397
2002	528496	47484	34987	1678
2003	570679	46668	23961	1876
2004	925716	122792	91404	2175
2005	888561	132507	86425	2985
2006	1415094	239336	151400	14285
2007	2198025	316863	228154	19594
2008	1969336	328121	223116	19257
2009	1175108	268476	210925	15927
2010	1451365	400144	273033	13151
2011	1711652	422582	304293	12456
2012	1346671	440164	302130	8486
2013	1410810	454067	3261013	1679

Source: Extracted from UNCTAD database, 2014.

Considering that nearly all the Indian enterprises undertaking outward investments had their origins in import-substitution based industrialisation strategies and the selective FDI policy regime, it would appear that the policy of infant industry protection with supportive institutional framework can assist in enterprise development by giving to them access to domestic market to grow and build capabilities (Ibid.). However, the protection needs to be phased out once the capabilities are built up to expose the enterprises to international competition and sharpen their competitiveness. In fact, the reforms of 1991 have sparked of a considerable restructuring of Indian industry which emerged from it leaner, more efficient and competitive. The exposure also gave to the Indian firms global ambitions and also the confidence to pursue them. In some ways, the Indian experience follows in the Japanese and Korean tradition of enterprise development policies and may have lessons for other developing countries.

The acquisition-based strategy of internationalisation adopted by Indian enterprises in the recent years by acquiring strategic assets, such

Policy of protection & supportive institutional framework helps SMEs to become MNEs but phasing out is imp

PA
MC
W

GI
wonder
EA

~~Not to
harm it
ask him
megaxs~~

to

22-06-20

open
① FDI policy
necessary but
not sufficient

In general, the above analysis brings out the role of government policy in attracting and benefiting from FDI inflows for development. In light of this discussion, we may now draw a few policy lessons for the region and other similarly placed developing countries.

↳ Annual. mono. perianth.

of FDI inflows by acting as a signaling device for foreign investors about the growth prospects for the potential host economy. Hence, paying attention to macroeconomic performance indicators such as growth rates of industry through public investments in socioeconomic infrastructure and other supportive policies, and creating a stable and enabling environment would crowd-in FDI inflows. Studies have shown that policies that facilitate domestic investments also pull in FDI inflows. While investment incentives may not be efficient, 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.

Other associated policies.

The evidence suggests that the government policies play an important role in determining the quality or developmental impact of FDI and in facilitating the exploitation of its potential benefits by host country's development. The various performance requirements such as phased manufacturing programmes, export performance requirements and domestic ownership requirements have also been employed by the governments to achieve their developmental policy objectives. Even with liberalised policy, some policy direction to FDI is desirable as has been demonstrated by the case of East Asian countries.

② Role of govt policies

→ X performance
→ LCR
→ Domestic equity

Crowd in domestic inv.

One way to maximise the contribution of FDI to the host development is to improve chances of FDI crowding-in domestic investments and minimise the possibilities of it crowd-out domestic investments. In this context, the experiences of Southeast Asian countries such as Malaysia, Korea, China and Thailand in channelling FDI into export-oriented manufacturing through selective policies and export performance requirements imposed at the time of entry deserve careful consideration (see Kumar, 2005b, for evidence). The export-oriented FDI minimises the possibilities of crowding-out of domestic investments and generates favourable spillovers for domestic investments by creating demand for intermediate goods. Another policy that can help in maximising the contribution of FDI inflows is to push them to newer areas where local capabilities do not exist as that minimises the chances of conflict with domestic investments. Some governments such as Malaysia have employed pioneer industry programmes to attract FDI in industries that have the potential to generate more favourable externalities for domestic investment (see UNCTAD 1999; 2001, for examples). Similarly because MNE entry through acquisition of domestic enterprises is likely to generate less favourable externalities for domestic investment than

X oriented FDI
→ spillover in I & G

greenfield investments, some governments discourage acquisitions by foreign enterprises (see Agosin and Mayer, 2000, for examples).

Another sphere where governmental intervention may be required to maximize gains from globalisation is in diffusion of knowledge brought in by foreign enterprises. An important channel of diffusion of knowledge brought in by MNEs in the host economy is vertical inter-firm linkages with domestic enterprises. Many governments—in developed as well as developing countries alike—have imposed local content requirements on MNEs to intensify generation of local linkages and transfer of technology (see Kumar, 2005b, for evidence). The host governments could also consider employing proactive measures that encourage foreign and local firms to deepen their local content as a number of countries, e.g., Singapore, Taiwan, Korea and Ireland, have done so successfully (see Battat *et al.*, 1996). The knowledge diffusion could also be accomplished by creating sub-national or sub-regional clusters of inter-related activities which facilitate the spillovers of knowledge through informal and social contacts among the employees besides traditional buyer-seller links. UNCTAD (2001) also highlights the policy measures employed by different governments in promoting linkages.

Investments made by governments in building local capabilities for higher education and training in technical disciplines, centres of excellence, and in other aspects of national innovation systems have substantial favourable externalities as is demonstrated by the case study of FDI in India's knowledge-based industries.

Finally, rising CAD poses an important challenge for policy makers and need urgent attention. With widening merchandise trade deficits driving this trend, immediate attention needs to be paid to reviving export growth and exploiting the opportunities for import substitution. For reviving exports, attention needs to be paid to strengthening their competitiveness by addressing exchange rate distortions. Export competitiveness needs to be strengthened by maintaining relative exchange rate stability with a slight tendency towards depreciation rather than appreciation. Besides that, policy distortions such as inverted duty structures need to be removed and flow of trade finance needs to be strengthened (see Kumar and Joseph, 2007, for an inventory of policy support measures). In a situation of slowdown of the global economy as at present, a major expansion of exports can be challenging given an environment of excess capacities throughout the Asia-Pacific region, the growing threat of protectionism and the temptation of dumping by those

Diffusion of knowledge

Creation of clusters of inter-related activities

Exchange rate distortions should be checked

Distorted duty structure should be removed

with deep pockets. In such circumstances, it might be also critical to look at new opportunities for, strategic import substitution. As observed earlier, while large bulk imports of fuels and raw materials may be price inelastic, attention should be paid to very large and fast growing imports of electronics, non-electrical machinery, and defence equipment, among others, that provide opportunities for strategic import substitution. An effort needs to be made to start domestic manufacture of these products leveraging India's large domestic market size and by targeting MNEs to set up local manufacturing facilities through creation of incentives for pioneering industries, as has been done in East Asian countries like Malaysia, besides incentives in public procurement like 'buy America' programmes. These policies are part of industrial policies and infant industry protection that have been widely practised in different developed and emerging economies (Kumar and Gallagher, 2007). The strategic import substitution will also lead to a more balanced structural change by creating more manufacturing jobs which is critical for poverty reduction (Kumar, 2013).

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