



Determinants of Foreign Direct Investment in India : A Macro Perspective

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Since the reforms of 1991, the inflow of FDI in India has been growing with fair and favour of various determinants. The aim of this paper is to provide an extensive explanation for FDI determinants regarding inflows as well as outflows in India. As a consequence of globalization and economic integration numerous variables affecting FDI have been discussed in this paper. It analyzes the dynamics of several FDI determinants in relation to the inflows and outflows. This paper examines, while the 'determinants of FDI' are often the objects of research, it is analytically cleaner and operationally more powerful to consider the determinants of different types of FDI. In literature survey the study found that numerous studies have lead a set of explanatory variables that are widely used and found to be significant determinants of FDI inflows and outflows. It reviews the key results of research regarding the determinants of FDI. Finally the study concludes that FDI inflows in India is simultaneously determined by policy framework, market size , economic factors as well as economic stability and political factors. The study also infers that there are similarities and dissimilarities in determining factors that explain FDI inflows to India and other under developed countries.

Key Words : FDI, Foreign Exchange, Trade

Introduction

'Capital and investments along with human resources are the essential hub of development'. This statement has gained and gaining lot of importance in recent times. FDI has been instrumental in economic growth of developed countries. Nearly every developed country has had the assistance of foreign finance to supplement its own meager savings during the early stages of its development. This has inspired India and other developing countries to reform their economic policies to attract FDI. India like many other countries attracts foreign direct investment as an important element in their strategy for economic development because FDI is widely regarded as an amalgamation of capital, technology, marketing and management.

In the liberalization era, India is known to have attracted a huge quantum amount of FDI. According to UNCTAD(2007) India has emerged as the second most attractive destination for FDI after China and ahead of the US, Russia and Brazil. While India has experienced a marked rise in FDI flows in the last few years. FDI inflows in India has increased from \$ 11.4 billion in 1990-99 to \$ 371.82 billion in 2009-10.

The paper is organized into 5 sections ,section I deals with conceptual clarification, section II is focused on the frame work of the study, section III literature survey on FDI determinants,

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section IV discusses the pull and push factors which determined FDI, and section V presents conclusion.

Conceptual Clarification

With the increasing scope of FDI, its conceptual clarification is essential. FDI is the process where by resident of one country (the home country) acquire ownership of assets for the purpose of controlling the production, distribution and other activities of a firm in another country (the host country). Balance of payment *manual* of International Monetary Fund (IMF) defined the FDI as a category of international investment that reflects the objective of obtaining a 'lasting interest' by a resident entity in one economy in an enterprise resident entity in another economy. The lasting interest implies the existence of a long relationship between the direct investor and the enterprise, and a significant degree of influence by the investor on the management of the enterprise.

However, RBI definition of FDI is more stringent since it excludes reinvested earnings, foreign equity listings, foreign subordinated loans to domestic subsidiaries, overseas commercial borrowings, financial listing, trade credits, grants, bonds, ADRs and GDRs. Whereas IMF Guidelines include all these under FDI. Thus there are differences in computation.

Focus and framework of the study

The main focus of this study lies in analyzing the behavior of some selected micro and macro pull and push factors of FDI determinants. The objective of this study is to observe and analyse the dynamics of some selected FDI determinants in relation to the inflows and outflows as a consequence of economic reforms in India. Different frameworks have evolved for analyzing the determinants of FDI, an exceptionally flexible and increasingly popular one is the eclectic theory of John Dunning. Accordingly the determinants of FDI could be considered on the basis of firm specific advantages, internalization advantages and countries' specific advantages. These advantages may be termed as 'push factors' of the host countries.

Literature Survey on FDI Determinants

An extensive set of determinants has been analyzed in the literature on the determinants of FDI. Numerous studies have lead to a set of explanatory variables that are widely used and found to be significant determinants of FDI inflows and outflows.

Markusen and Maskus (1999) Love and Lage-Hidalgo (2000), Lipsey (2000), and Moosa (2000), highlight how the domestic market size and differences in factor costs can relate to locational FDI. From the point of view of foreign investors this factor is important where the industries are characterised by relatively large economies of scale.

Labour cost which is one of the major components of the cost function deter FDI. It is true for the firms, which engage in labour intensive production activities. Various studies by Kravis and Lipsey (1982) Wheeler and Mody (1990) Lucas (1993) Wang and Swain (1995) and Barrell and Pain (1996) found no significant negative relationship of wage and FDI. Nonetheless there are other researchers Morre (1993), Love and Lage Hidalgo (2000) who have found out that higher wages do not always deter FDI in all industries and have shown a positive relationship between labour cost and FDI.

Gostanga (1998) and Asiedu (2002) focus on policy reforms in developing countries as determinants of foreign direct investment inflows. They considered corporate tax and degree of openness to FDI as determinants. Ethier (1994) Brainard (1997) Cars, Markusen and Maskus (2001) highlight the effect of tariffs on FDI in the context of horizontal and vertical specialization with MNC's.

Froot and Stein (1991) claimed that a depreciation of the host currency should increase FDI in to the host country and conversely an appreciation of host currency should decrease FDI.

Sayek Selin (1999) explained the negative relationship between inflation and FDI. Higher inflation cause low inflow of FDI in host country.

Hymer's (1960) market imperfection hypothesis postulated that FDI was the direct result of an imperfect global market environment. This approach successfully analyzed the 'tariff jumping' FDI which was prevalent in the countries encouraging import substituting industrialisation policies in the late seventies. In the eighties there was a need to explain the rising volumes of FDI despite the world markets becoming integrated.

Rugman (1960) in his "internalization theory" explained FDI in terms of a need to internalize transaction costs so as to improve profitability and explained the emergence of efficiency seeking FDI.

According to Dunning (1993, in his OLI theory) FDI takes place owing to ownership internalization and locational advantages. Ownership advantages are Firm-specific competitive advantages which an investing firm possesses over local firm in serving particular markets. These include unique assets relating to technological know how, marketing expertise, and managerial skills. The locational advantage of the host countries are natural resources, cheap inputs, large markets and so forth. To minimize transaction costs and increase profitability, investing firm must exploit their ownership and locational advantages through "internalization".

Traditional theories have characterised exports and FDI as alternative strategies. The growing complexities in the relationship between trade and FDI in the globalised era of integrated markets have led to the emergence of new approaches to study them. Gosse and Trevino (1996) in their study indicate that FDI used to preserve markets that were previously established by exports. Eaton and Tamura (1994) suggest that FDI follows exports, following Mundell (1957) it was long thought that FDI substituted trade. Further there have been some studies that have explored the relationship between FDI and trade by taking unified approach. In which the two flows are determined simultaneously.

Globerman and Shapiro (1999) found that the regional trade agreements caused both inward and outward FDI. Blomstrom and Kokko (1998) separated the effects of regional trade agreements along two dimensions, the indirect effect on FDI through trade liberalization and direct effects from changes investments rules connected with the regional trade agreements. According to them lowering interregional tariffs can lead to expanded markets and increased FDI, but lowering external tariffs can reduce FDI to the region if the FDI is tariff-jumping.

Number of studies indicating productivity spillover from FDI. Caves(1996), Globereman (1979), Blomstorm and Wolf (1994), Daankov and Hockman (2000) and Banga (2004) opine

that the higher the inflow of FDI, the higher will be the capability of domestic investors to undertake investments abroad.

Kyrkills and Pantilidies (2003) noticed that income is the most important determinant of FDI inflows for Germany. In addition they also discovered that exchange rate is an influential factor in affecting the outward FDI to Brazil and Singapore. Prugel (1981), Lall (1980), Grubangh (1987) finds low interest rate in the home country relatively will lead to higher tendency of outward FDI. Exchange rate also has significant impacts towards the outward FDI.

Hosmane Manjappa D. R.Niranjan (2010), in their paper ‘Determinants of investment pattern in Indian manufacturing industries; A panel data study’ made an attempt to assess the determinants of investment patterns of Indian manufacturing sector over the year, at an aggregate level of major industry group. The aim of this paper is to examine the role of accelerators and financial variables affecting investment.

Determinantal Factors of FDI in India

Economic literature has identified various factors that motivate inward FDI flows and outward FDI flows. Aykut and Ratha (2003) have broadly catagorised the determinants of FDI into demand side pull factors and supply side push factors from the Asian developing countries. Pull factors are the micro and macro charecterstics of the host country markets that attract FDI towards them and push factors are the micro and macro charecterstics of the home country that push outward FDI into the destination economies.

Table : 1
Determinants of FDI

Pull factors Determining FDI inflows.	• Policy framework of FDI in India.	Liberalized industrial policy, liberal trade policy, foreign exchange policy, exchange rate regime, intellectual property regime, tax policy of government.
	• Market size and GDP	Size, income levels, urbanization, stability and growth prospects, access to regional markets, distribution and demand patterns.
	• Economic determinants.	Foreign exchange reserve, infrastructure, cost of capital or interest rate, cost of labour.
	• Economic stability.	Debt- GDP ratio, industrial disputes inflation rate, deficit in the balance of payments.
	• Political factors.	Political stability and freedom from external aggression, security of life and property, reasonable opportunities for earning profits, prompt payment of faired and transferable compensation in case of nationalization of a foreign owned enterprises, facilities for immigration and employment of foreign personnel, freedom from double taxation, a general spirit of friendliness toward, foreign investors.
Push factors Determining FDI outflows.	Exports, imports, FDI inflows.	

Major Pull Factors Determining FDI Inflows in India

Pull factors are locational specific characteristics of the host country markets that induce home country investments. So an effort is made to explain the location factors in India as follows.

I. Policy framework OF FDI in India: Government policies are a possible determinants of FDI since the Government considers FDI flows as means to fight unemployment and enhance national growth rate. The significant policies are liberalized industrial policy, trade policy, tax policy, intellectual protection regime, international trade agreements of a country etc.

- (a) **Liberalised industrial policy:** Industrial policy liberalization is one of the most important determinantal factors of FDI in India. Several liberal policies have been adopted in 1991. This policy observes that while freeing the Indian economy from official controls, opportunities for promoting foreign investment in India should also be fully exploited and liberalised the Indian policy towards foreign investment and technology.

In the preliberalisation era, foreign equity participation was restricted normally to 40 percent and technology agreements needed prior approval. As against this, the neo policy has allowed 51 percent foreign equity participation and also allowed majority foreign equity with automatic approval in a large number of industries.

In January 2005, for example the Government relaxed restrictions on new FDI in India by foreign partners of joint ventures. The previous rules, issued in press note in 1998, had required a release by the Indian partner and government of India approval for any new investment, a provision often subject to abuse. The new rules maintain restrictions on the majority of existing joint ventures, but have new ones to negotiate their own terms on commercial bonds. A local firm's ability to restrict its foreign partner's business strategy has been reduced, but the way out of a current joint venture remain uncertain.

FDI policy liberalization is a very necessary but not a sufficient determinant of FDI as the case in Africa where regulatory frameworks in most countries are quite open but FDI inflows remain low. So other determinants have come into play a crucial role for investment to flow into the country.

- (b) **Liberal trade policy :** Theoretical literature suggest that liberal trade regime of host country may have two counteracting influences on the inflow of FDI. Firstly, open regimes that facilitate intra-firm trade, allow greater freedom to TNCs and are export-friendly may make the host country a better place to do business for foreign enterprises and FDI inflows may increase. On the other hand, restrictive trade regime with high tariffs offer a locational advantage for tariff jumping import substituting FDI by TNCs.

In India there have been many trade policy changes since 1991. The export-import policy since 90s has eliminated to a substantial extent quantitative restrictions, licensing and discretionary controls. The changes include de-licensing and substantial reduction of tariffs on import of capital goods, raw materials and components, re-classification of tariff categories, and permission to foreign companies engaged in manufacturing and trading activities to open branch offices in India. As a result all goods can now be freely imported and exported.

The change in the policy attitude reflects the Governments commitment to the idea that foreign trade and FDI flourishes in an atmosphere of freedom.

- (c) **Foreign exchange policy and exchange rate regime :** Foreign exchange policy represents the investment climate in the country. There have been some changes introduced in the foreign exchange regulations in India. The amendment to FERA has

removed a major hurdle to the FDI inflows into the Indian industry. The operating environment has received a major fillip with the introduction of a single market determined exchange rate for the rupee since 90s. All import and export transactions are now conducted at the market rate of exchange. The market rate also applies to other transactions like payments in respect of repatriation of dividends, jump-sum fees and royalties and foreign trade. And the Government introduced current account convertibility in 1994.

- (d) **Intellectual property protection regime** : The Uruguay round negotiations presumed that stronger patent regime improves the investment climate in the host country and encourages the inflow of foreign direct investment, Intellectual property protection links more directly with R&D activity. MNCs may be apprehensive of locating their key R&D centers in countries with weak patent regimes. Therefore, the relative strength of patent protection available in a country may be a factor in determining the overseas R&D activity of the MNC's. As India is a signatory of Uruguay round negotiations which strongly protect IPR has good environment for host countries to invest in India.
- (e) **Tax policy of government** : Fiscal policies determine general tax levels, including corporate and personnel tax rates and thereby influence inflow of FDI. Any change in tax rates on corporate income like dividend, royalty, technical fees and capital gains received by a foreign company is expected to influence the inward flow of FDI. In India during 1993-94 the tax rate on short term capital gains were reduced from 75 percent to 30 percent. An Electronic Hardware Technology Park (EHTP) scheme was set-up to allow 100 percent equity participation, duty free import of capital goods and a tax holiday.

II. Market size and GDP :Market size, income of its population and GDP growth are considered as important determinants of FDI in India. Large markets can accommodate more firms both domestic and foreign can help producing tradable products to achieve scale and scope of economics. As growth is a magnet for firms, a high growth rate in host country tends to stimulate investment by both domestic and foreign producers. Traditionally market size and growth as FDI determinants relate to national market for manufacturing products which is sheltered from international competitions by high tariffs or quotas that triggered tariff jumping. The commerce department of USA calls India as one of the 10 emerging markets in world, which means that big growth in investment will come to the big emerging markets from the developed countries. Similarly the World Bank has categorized India as the fifth largest economy of the world after USA., China, Japan and Germany. The largest market cause high GDP growth and there by attract huge FDI.

A high average annual GDP growth of 6.6 percent from 1991 to 2006, and 7 to 8 percent till 2010 and gradual improvement of its market mechanisms attracted world wide attention with emerging investment opportunities and huge market size.

III. Economic determinants of FDI : The economic determinants of FDI are as follows.

- (a) **Foreign exchange reserve** : The higher level of foreign exchange reserve in terms of import cover reflects the strength of external payment position and helps to improve the confidence of the prospective investors. Increasing foreign exchange reserve implies improving financial health of a country which induce FDI. India has managed to build up its foreign exchange reserve to the desired level during the reforms period. India's

foreignexchange reserve in dollar term has increased by around 60 times from 2.23 billion US Dollar in march 1991 to 135.57 billion Dollar in 1991, 263.1 billion Dollar in 2009 and to 299 billion Dollar in January 2011. It shows her strength of external payment position. Therefore higher level of foreign exchange reserve leads to inflow of more FDI.

- (b) **Infrastructure** : Availability of lower cost infrastructure enables the host country to attract more FDI. The establishment of industry requires developed infrastructure. In 2006, India has 3.3 million kilometers of roads out of which 66 thousand kilometers are national highways and 40 percent of transport uses this 2 percent roads, 5846 kilometers of roads connecting the five corners of the country. The biggest challenge of infrastructure is power, which is now being well taken care both in the production and distribution aspects. There are more than 135 million telephone connections in India. These infrastructural facilities are responsible for the attraction of FDI in India.
- (c) **Cost of capital or interest rate** : Cost of capital is another important component of financial cost. Generally foreign firms try to reduce their financial cost in order to maintain price competitiveness. RashmiBanga (2003) found that the availability of capital at cheap lending rate may enable the foreign direct investors not only to locate better partners in the host country with sufficient domestic investment to supplement but also maximize the return on their investment. Hence easy availability of capital at cheap rate in the host country would attract the direct investors from foreign countries. It can also be argued that the host country's cost of capital lend its impact directly on domestic consumption. Thus lower the cost of capital in the host country, the higher the domestic consumption and hence higher the FDI inflows. Element of interest represents the component of cost in the Indian production system, since long time which may hold back investors from investing.
- (d) **Cost of labour** : Cost of labour is one among the factors that cause investment costs differential across the countries. So wage differential is one factor which can ensure profit by creating a low cost atmosphere to attract multinational investment in the host country. Foreign direct investment does flow to the countries where there is availability of comparatively cheap labour than in the home countries.

The survey conducted by Mercer Human Resource consulting, the world largest employees consultancy, shows that labour costs in India are among the worlds lowest. So, it is ensure that in India the low labour cost create low cost atmosphere to attract multinational investment.

IV Economic stability : Economic stability of the country strengthen the economy to attract FDI. The stability factors those which determine FDI are as follows :

- (a) **Debt-GDP Ratio** : Increasing debt liabilities would deteriorate the financial health of country ultimately cause the instability in the economy. Lower the external debt to GDP ratio, higher is the profitability of economic stability and inflow of FDI. The level of indebttness exhibits the burden of repayment and debt servicing on the economy and making the country less attractive for foreign investors. Consistent reforms in India made possible to recover from "debt trap", "Debt-GDP" ratio began to fall from 38.7 percent in 1990-91 to 17.6 percent in 2003-04. Debt service ratio is also declined from 35.3 percent in 1990-91 to 14.1 percent in 2001-02 due to the sharp fall in the

rates of interest in the world market. India is expected to attract more FDI with the declining trend of Debt-GDP ratio.

- (b) **Industrial Disputes** : Any industrial disputes capable of increasing production costs through labour cost and work stoppage, hampers the production process. Hence, industrial disputes are potential constraint for foreign direct investment. Foreign investors would prefer to invest only in those locations where there is continuous availability of labour and less number of strikes.
- (c) **Inflation rate** : Inflation is harmful to economic stability of host country. It is a sign of internal economic tension. In this environment, Government unable to balance the budget and RBI restrict the money supply so it cause low FDI inflows.
- (d) **Deficit in the balance of payment** : A large deficit in the balance of payment indicates that the country lives beyond its means. The danger decreases the free capital movement and that it will be more difficult to transfer the profits from the direct investment into the investing country.

V. political factors : United Nations Economic Commission for Asia and the Far East has drawn up some conditions that have to be met if foreign capital is to be attracted to underdeveloped countries. They are political stability and freedom from external aggression, security of life and property, reasonable opportunities for earning profits, prompt payment of fair and transferable compensation in case of nationalization of a foreign owned enterprise, facilities for immigration and employment of foreign technical and administrative personnel, freedom from double taxation, a general spirit of friendliness towards foreign investors.

Push Factors Determining FDI Outflows from India

The most important push factors of outward FDI are exports, imports and FDI inflows. Higher exports may assure the home country firms of the existing markets in the foreign economies and therefore, lower the risks and uncertainties attached to out ward FDI. As far as imports' determinant is concerned, the Indian economy which had protectionist policy for long period, opened up in the early 90's through complete removal of non tariff barriers and drastic reduction in import duties. This led to import competition that could probably be a push factor for the recent growth of outward FDI from India. FDI inflow is an another important constituent factor which could be complementary to FDI outflows. Higher FDI inflows may also enhance the capability of home country in undertaking outward FDI, by enhancing the flow of non-debt private capital and technological and managerial skills, creating domestic employment through backward linkage effects and also by building up the foreign exchange reserves of the country. This is relevant for India.

Conclusion

Over a period of time general and specific FDI policies have become less restrictive to inward FDI policies in India with fewer policy barriers. However, other factors have become emerged as important determinants of FDI. Prominent among them are basic economic pull factors such as good quality and productive human resources on the supply side and market size on the demand side. Macro economic policies that shape the underlying fundamentals of cost competitiveness, economic stability of the country and degree of

integration with the world economy have also become more important over time in attracting FDI. The significance of specific determinants appears to be dependent upon the type of FDI. While some determinants such as socio political stability could well be relevant for every kind of investment, other determinants may not be capable of explaining all types of FDI. For example, the size of domestic demand, income growth cannot explain investment in small low income developing countries. Such investment, therefore, is unlikely to be of the market seeking type. Similarly, labour costs are unlikely to be very relevant in the case of (natural) resource-seeking FDI.

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