FDI AND ITS DETERMINANTS OF INDIA

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ABSTRACT

Foreign direct investment (FDI) is recognized to contribute to benefits of economic and social development. Foreign direct investment (FDI) is an integral part of an open and effective international economic system and a major catalyst to development. FDI has become an increasingly more important factor of economic growth. Between 1986- 1989 and in 1995 the rate of FDI grew more rapidly than world trade in goods. Between 1973 and 1995 the value of FDI multiplied by more than 12 times, form $25 billion to $315 billion, while the value of commodity exports multiplied by about eight and a half times, form $575billion to $4900 billion. In many cases the value of FDI flowing into a country exceeds the level of official government aid to that country. In brief, while the value of international trade in goods is still far greater than the value of FDI, FDI plays an important role for economic development. The economic growth of foreign direct investment (FDI) in recent decades has generated three main current of thought which have attempted to explain this phenomenon. First the market imperfections hypothesis Kindle Berger (1969) Hymer (1972), which postulates that FDI is the direct result of an imperfect global market environment. Second, the internalization theory Rugman (1985 & 86), where FDI takes place as multinational replace external markets with more efficient internal ones, and third, the eclectic approach to international production Dunning (1986, 1988) where FDI emerges because of ownership, internalization, and location advantages. Foreign direct investment (FDI) has been one of the fascinating and intriguing topics among researchers in international business. It is one significant form of rapid international expansion to increase ownership of assets, derive location-specific advantages and acquire additional knowledge. In the existing empirical studies, the following model has been used to explain the determinants and its impact of SAARC nations. FDI and competitiveness suggest that the basic determinants of the inflows of FDI's are 3 key variables: Size of the market, Growth of the market and the exchange rate of the country. FDI $t = a_0 + a_1$ GDP $t-1 + a_2 \Delta$ GDP $+a_3$ (I/GDP) $t-1 + a_4$ XR $t + U$. This research paper is trying to find the influence of determinants and its influence on FDI of India.

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INTRODUCTION

Foreign direct investment (FDI) is recognized to contribute to benefits of economic and social development. In addition it is also a channel through which countries different characteristics confront one another. The developing countries attempt to promote investment and create a sound investment climate for attracting foreign investors to their countries. As a result, FDI inflows are regarded as vital complements to development efforts.

Foreign direct investment (FDI) is an integral part of an open and effective international economic system and a major catalyst to development. FDI usually represents a long-team commitment to the host country and contributes significantly to gross fixed capital formation in developing countries.

DEFINITION OF FOREIGN DIRECT INVESTMENT

It is observed that there is serious conceptual ambiguity in understanding FDI. Following definitional aspects of FDI have been cited from world investment directory to facilitate a better understanding of the phenomenon (UNCTAD: 2000:51-53). The two main definitions of FDI are contained in the balance of payments manual (Washington, D.C., International monetary fund, 1977 and1993) and the second edition of the detailed benchmark definitions of foreign direct Investment (Paris, organization for economic co- operation and Development, 1992 and 1996) according to the balance of payments manual, FDI refers to investment made to acquire lasting interest in enterprises operating outside of the economy of the investor. Purpose is to gain an effective voice in the management of the enterprise.

According to the benchmark definition of the OECCD, a direct investment enterprise is an incorporated or unincorporated enterprise in which a single foreign investor either owns 10 per cent or of the ordinary shares or voting power of an enterprise (unless it can be proved that the 10 per cent ownership does not allow the investor an effective voices in management). An effective voice in management only implies that direct investor is able to influence the management of an enterprise and does not imply that they have absolute control. The most important characteristics of FDI, which distinguishes it from portfolio investment, is that it is undertaken with the intention of exercising control over an enterprise.

FOREIGN DIRECT INVESTMENT AND ECONOMIC GROWTH

The economic growth of foreign direct investment (FDI) in recent decades has generated three main current of thought which have attempted to explain this phenomenon. First the market imperfections hypothesis Kindle Berger (1969) Hymer (1972), which postulates that FDI is the direct result of an imperfect global market environment. Second, the internalization theory Rugman (1985 & 86), where FDI takes place as multinational replace external markets with more efficient internal ones, and third, the eclectic approach to international production Dunning (1986, 1988) where FDI emerges because of ownership, internalization, and location advantages. Foreign direct investment (FDI) has been one of the fascinating and intriguing topics among researchers in international business. It is one significant form of rapid international expansion to increase ownership of assets, derive location-specific advantages and acquire additional knowledge. Many scholars have followed either of two schools of thought in explaining FDI. The microeconomic approach Hymer (1976), caves 1974 :) attempts to explain why firms of one country are successful in penetrating into other markets while the macroeconomic approach (Buckley and Casson 1976; Grosse and Trevino 1995) tries to examine why firms seek international expansion.

Both theory and evidence form regional integration arrangements suggest that measures that reduce trade costs among partner countries may provide and important stimulus not only to trade, but also to foreign direct investment (FDI) flows between member countries, as well as, between member countries and outsiders. The SAARC integration initiatives have taken place in the context of a significant (non-discriminatory) liberalization process in all member countries. This has involved both trade and investment liberalization, and the adoption of a pro- FDI stance. Though significant trade and investment barriers remain in place in many countries the regional economies today far more open than they were until the late 1980's.There is a general acceptance that expanded trade, as well as FDI, confers large net benefits. However, though intra-SAARC trade has been quite extensively analyzed, the FDI-trade nexus has received relatively little research attention in South Asia.

In recent times, the liberalization process in the region has infused dynamism to the region's economies in several ways. Economies are becoming more open, outward oriented, and more receptive to foreign investment and trade; at the same time, many business firms are expanding their horizons, and are not only entering into joint ventures and other partnerships with foreign firms but are also taking the initiative to undertake FDI in other countries . The theories of

horizontal and vertical FDI developed a unified theoretical framework incorporating both vertical and horizontal FDI.

Recent studies along this line include those by Asiedu (2002); Elbadawi and Mwenga (1997); Noorbakhah and Paloni (2001); Sadik and Bolbol (2001); Pigato (2000); De Mello (1997); Singh and Jun (1995) Gastanaga et al. (1998); collier and Pattillo (2000); sin and Leung (2001); Shi (2001) and Chemingui (2000). Addison and Heshmati (2002) recently added a new dimension and therefore new determinants to this strand of the FDI literature. They examined recent changes in the global economy in terms of new information and communication technology as likely determinants of a developing country's ability to attract FDI. The two variables capturing these developments were found to have positive effects on the inflow of FDI even though information, communication and technology were observed to be country specific in its effect on FDI inflows.

FDI has become an increasingly more important factor of economic growth. Between 1986-1989 and in 1995 the rate of FDI grew more rapidly than world trade in goods. Between 1973 and 1995 the value of FDI multiplied by more than 12 times, form $25 billion to $315 billion, while the value of commodity exports multiplied by about eight and a half times, form $575billion to $4900 billion. In many cases the value of FDI flowing into a country exceeds the level of official government aid to that country. In brief, while the value of international trade in goods is still far greater than the value of FDI, FDI plays an important role for economic development.

Developing and transition nations have a particularly strong interest in attracting foreign capital. Domestic savings are often insufficient in these countries to finance their investment needs. This capital shortage affects both public and private investment. The Asian development bank predicts that the demand for infrastructure investment in Asia alone will reach $150 billion annually by 2010. The World Bank forecasts the need for investment between $ 1.2 and $1.5 trillion in infrastructure development in developing East Asian countries. Foreign investment is also a key component of privatization schemes in transition economies in central and Eastern Europe. The privatization process in the Czech Republic, Hungary, and Poland as well as in countries like Slovakia, Bulgaria, and Romania, has actively pursued foreign capital.

POSITIVE IMPACT ON DEVELOPMENT

While many observers believe that much of the FDI in the financial and infrastructure sectors yielded little impact, this perception does not stand up to in-depth analyses such as those by Luis Guasch (2002), Clive Harris (2003), and the McKinsey Global institute (2003). These studies have shown that in almost all cases FDI had a largely positive impact on productivity and on the coverage of services. Brian Portelli reviews the relationship between foreign direct investment (FDI) and growth and argues that this must be maximized through a comprehensive approach to industrial policy in recipient countries. Specifically, the author believes that domestic firms must develop the necessary for profiting from the potential externalities of FDI. Matthew J. Slaughter examines the theory and empirical evidence on how multinational corporations (MNCs) and foreign direct investment (FDI) affect the supply and demand for skills in host countries. Using data from both developed and developing nations, the author finds a strong positive correlation between skill upgrading and the presence of local affiliates of U.S. MNCs.

IMPLICATION OF FDI FOR POVERTY ALLEVIATION

It is widely believed that, given the appropriate host-country policies and a basic level of development, benefits that might accrue from FDI include employment creation, the acquisition of new technology and knowledge, human capital development through employee training in new business ventures, contribution to international trade integration, creation of a more competitive business environment and enhanced local/domestic enterprise development, flows of ideas and global best practice standards aiding international competitiveness and increased tax revenues from corporate profits generated by FDI. All of these forms of benefits are expected thus to contribute to higher economic and employment growth, which is the most important/ effective tool for achieving improvements in human wellbeing or alleviating poverty in developing countries. Unfortunately, empirical evidence regarding what impact FDI has had on poverty reduction in developing countries is limited, including in where so far there is only a few studies tried to analyze empirically this relationship.

THEORETICAL APPROACHES ON FDI

There are three theoretical approaches which are either popular in literature or useful for our purpose, or even both: (1) Vernon's product cycle approach; (2) Dunning's eclectic paradigm;

(3) company size approach. As we argue on a micro data basis, it makes sense to explain FDI and its impact through theoretical approaches related to single firms. (1) Vernon's product cycle approach explains FDI as a firm's reaction to product imitations by rivals, or to a drop in sales because of domestic market saturation. A product innovation, which is in an advanced stage of the product cycle after successful market introduction and standardization of production, could require FDI for two reasons: firstly, domestic markets could be supplied at lower prices by a network of traditional expensive domestic production plants and new foreign production plants with lower production costs. This leads to relatively lower consumer prices by mixed calculation which could increase total sales again. Secondly, there is a chance of increasing exports through foreign   sales affiliates which are closer to the local markets (cf. Adebahr 1981, pp. 113; Deitmers 1982, pp. 208). Actually a positive relation between FDI and exports has been observed empirically (cf. Gundlach/ Nunnenkamp 1994, pp. 212; Hartel/Jungnickel 1998, p. 124). Empirical support for the product cycle approach is rare, because real enterprises produce several products at the same time which are at different stages of the cycle. Thus, FDI flows are difficult to relate to single FDI-projects and product innovations. (2) Dunning's eclectic paradigm explains FDI by a simultaneous occurrence of three necessary conditions for a domestic parent company: (1) company-specific competitive advantages, e.g. product innovation, management know-how; (II) internalization advantages, e.g. protection against foreign cooperation partners who might imitate the domestic firm's competitive advantages; (III) location advantages, e.g. lower Labour costs, faster working bureaucracy (cf. Dunning 1991, pp. 120-125). (3) according to the company size approach bigger companies realize various advantages compared to small and midsize enterprises. These advantages result form more experience in doing business in foreign markets and from bigger financial resources. Therefore, it can easily be understood that small manufacturing firms with little experience in foreign markets will hesitate to undertake FDI (cf. Fujita 1998, pp. 140). There are empirical findings which support these considerations (cf. Knodler 1999b, p. 33; Lobbe et al. 1997, p. 142).these theoretical approaches can be used to explain different kinds of FDI, e.g. establishment of foreign production plants or equity participation at foreign trading companies. Modifications of these theoretical approaches could also help in understanding national investment flows between different regions within a country, certainly with different emphasis because the location disparities will be smaller within a country than between regions form different countries.

Rashmi Banga (2002) reviews the literature on the relationship between foreign direct investment (FDI) and exports. It then examines the effects of FDI on India's exports and finds that FDI has had a significant effect on the export-intensity of industries in non-traditional exports; Japanese investments have not had the same effect. Kyoji Fukao, Hikari Ishido, Keiko Ito begins with and overview of the major characteristics of economic development and integration in east Asia and the Unites States. The paper concludes that foreign direct investment (FDI) has played a significant role in the increase of intra-industry trade in vertically differentiated products

Syed Aziz Anwar (1999) analyzed the reassessing determinants of FDI in some emerging economies and used econometric model:

$$FDI = a_0 + a_1 \, GDP \, t\text{-}1 + a_2 \, \Delta GDP + a_3 \, (I/GDP) \, t\text{-}1 + a_4 \, XR \, t + U$$

Concludes that the FDI plays all important roles in the low-income emerging economies Economic liberalization has emerged as a fruitful policy track being pursued by so many developing counties as it attracts invaluable foreign capital and technology in the forms of FDI.

DETERMINANTS OF FOREIGN DIRECT INVESTMENT

Some of the independent variables are normally determine the flows of FDI to a particular country called determinants. Research focusing on the determinants of FDI, the data has been collected based secondary resources. Empirical studies focusing on the determinants of FDI in a particular country depends of four important variables: (i) Size of the market (ii) Openness of Economy (iii) Growth of the market (iv) Exchange rate of the country. (Huffoaur, Lakdawalla, and Malani, Syed Aziz)

In the existing empirical studies, the following model has been used to explain the determinants and its impact of SAARC nations.

FDI and competitiveness suggest that the basic determinants of the inflows of FDI's are 3 key variables:

a. Size of the market.
b. Growth of the market.
c. The exchange rate of the country.

$$FDI \, t = a_0 + a_1 \, GDP \, t\text{-}1 + a_2 \, \Delta GDP + a_3 \, (I/GDP) \, t\text{-}1 + a_4 \, XR \, t + U$$

Where,

FDI   =   *Foreign Direct Investment.*
Δ GDP t-1   =   *Gross Domestic production in the previous year.*
Δ GDP t   =   *Change in GDP in the year t.*
(I/GDP) t-1   = *Ratio of domestic investment to GDP in the year t-1*
XR t   = *Exchange rate in year t. (REER) Real effective exchange rate.*
U   = *Effects of other variables (or) error term.*

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Y $= a_0+a_1 GDP_{t-1}+ a_2 \Delta GDP+a_3 (I/GDP)_{t-1} + a_4 XRT + U$
Y   = *Foreign Direct Investment to India.*
GDP_{t-1} = *Gross Domestic Product in the previous Year.*
ΔGDP t   = *Change GDP in the year t*
(I/GDP) t-1   = *Ratio of domestic investment to GDP in the year t-1*
X Rt   = *Exchange rate in year t(REER)Real effective exchange rate*
U   = *Effects of other variables (or) Error Term.*

VARIABLES	RESULTS
Constant (A)	6346.85
GDP_{t-1} (β_1)	-1.1(-.90)
ΔGDP (β_2)	.69(.55)
$(INVT/GDP_{t-1})$ (β_3)	.39(.62)
Ex Rt (β_4)	-.32(-.55)
R Value	.84
Adj.R^2	.95
F Value	65
DWS	1.71

Figures in the parentheses denote- t value.

CORRELATION ESTIMATES OF FDI & ITS DETERMINANTS OF INDIA
WHOLE PERIOD OF STUDY

CORRELATION	GDPt-1	ΔGDP	GDI/GDPt-1	X RATE	FDI
GDPt-1	1.000000	.956916	.332717	.158251	-.332525
ΔGDP	.956916	1.000000	.399944	.166236	-.232081
INVT/GDPt-1	.332717	.399944	1.000000	.796812	.059460
X RT	.158251	.166236	.796812	1.000000	-.060456
FDI	-.332525	-.232081	.059460	-.060456	1.000000

The gross domestic product (GDP) is one the primary indicators used to gauge the health of a country's economy. It represents the total dollar value of all goods and services produced over a specific time period - you can think of it as the size of the economy. Usually, GDP is expressed as a comparison to the previous quarter or year. For example, if the year-to-year GDP is up 3%, this is thought to mean that the economy has grown by 3% over the last year. The model has been estimated for the variables full period from 1997 – 2008. This model explaining, the co-efficient associated with GDP_{t-1} is -1.1, it implies that for every unit increases in lagged income in increase the FDI inflow in India has decreased-1.1 units. This value does not satisfy the theoretical expectation. The co-efficient of parameter growth of GDP (β_2) is 0.69.This means for every one unit increase in GDP the FDI inflow into India increase by 0.69 units. This value satisfies the theoretical expectations.

Another variable that is hypothesized to determine FDI is the ratio of Investment to GDP. When a larger proportion of GDP is allocated for investment the demand for capital goods increases, in order to exploit this demand hike, foreign investors bring in the investment .The response of the FDI, however depends upon a host of other factors take the government policy etc., Hence, the co-efficient associated with I/GDP is β_3 less than one. The estimated β_3 is 0.396, which means that for one unit increase in the ratio (I/GDP) the FDI increases by 0.396 units during the period. This value satisfies the theoretical expectations.

The real effective exchange rate is considered to be other variable. In this model associated with β_4 assumes a negative value of -0.32.This value satisfies the theoretical expectations. R value is 0.84 .As per the value of co-efficient of determination adjR^2 is 0.95 nearly 95 percent of variations in the FDI in India are explained by the changes in the hypothesized variables. The estimated F - value is 65. This explains the general acceptability of the model. The analytical exercise carried out, makes it clear that during 12 years period the variable except GDP_{t-1} other variables are theoretically satisfies.

CONCLUSION

India has been a major country of FDI Inflows in the major of sectors. During the liberalization period, Indi has attracted a quantum amount of Foreign Direct Investment, especially after the liberalization. The huge market for computer hardware Industry and soft ware Industry. More skill professionals are cause for high growth prospects, in terms of increased consumption in the India as well as increasing demand for exports are expected to lead to more Foreign Direct Investments. FDI opportunities in the telecommunication sector in India exist in the areas of E-commerce, Manufacturing of equipments and components, Tele-education, Telebanking, Exports of telecom equipment and services, Telemedicine, Setting up a national long distance bandwidth capacity in the country. Construction projects which have received the maximum FDI include, housing, commercial premises, hotels, resorts, hospitals, educational institutions, recreational facilities, city and regional level infrastructure. FDI Inflows in the construction industry in India are permissible under automatic route to ensure flexibility in construction activities which will boost the Indian economy. In the real estate sector, the foreign investors are not allowed to sell undeveloped land, such as, lands which do not have proper facilities of roads, water, electricity, drainage and all other basic requirements for inhabitation. The analysis indicated that the India's size of the market has been expanded due to FDI inflow. The growth of the markets is also increased at significant level. But the exchange rate has influenced negatively on FDI inflow because of changes in the value of currencies.

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