

# An Analytical Study Of Role Of Foreign Direct Investment (FDI) In India And Its Impact On Trade Development-II.

Mr. Arun Sharma  
Assistant Professor,  
Amity University Madhya Pradesh, Gwalior.

## Abstract

The purpose of the paper is to highlight the role and impact of Foreign Direct Investment (FDI), the problems associated with the provisions of Foreign Direct Investment in India. In this paper an attempt is also made to discuss the various constraint and limitations of Foreign Direct Investment. The findings of the paper will help the planners to frame an exact and benefiting policy for Foreign Direct Investment and its role in economic development of India.

**Keywords:** Foreign Direct Investment, Economic Development, Investment.

## INTRODUCTION:

Foreign direct investment plays a very prominent role in the development of global economy in general and global business in particular. In simple words, Foreign direct investment (FDI) is an investment made by a firm or individual in one country into business interests located in another country. Generally, FDI takes place when an investor establishes foreign business operations or acquires foreign business assets, including establishing ownership or controlling interest in a foreign company. Foreign direct investments are distinguished from portfolio investments in which an investor merely purchases equities of foreign-based companies.

## IMPACT OF FOREIGN DIRECT INVESTMENT IN INDIA

The impact of FDI on economic growth is one of the most controversial topic in the literature of international political economy. According to the generally held view, FDI promotes economic growth by providing external capital and through growth, spreads the benefits throughout the economy. It is the presence, rather than the origin of investment, that is considered to be important, because FDI usually brings with it advanced technology, and better management and organization.

Another generally held view, the dependency hypothesis, while admitting a possible short-term positive impact of the flow of FDI on economic growth, contends that there is deleterious long-term impact of FDI on economic growth, as reflected in the negative correlation between the stock of FDI and growth rate. In

the short run, an increase in FDI enables higher investment and consumption and thus contributes to economic growth.

In addition, some have argued that political, social and cultural factors play crucial roles in determining the growth performance of Developing Countries. Others have argued that the impact of FDI on economic growth might vary across countries because of different stages of development.

However, recent theories of economic growth emphasize the importance of knowledge and information as a determinant of economic growth. Empirical measures of knowledge generally focus on skill levels and R&D (Research and Development) activity. But since almost all of the R&D activity takes place in the advanced economies of the OECD (Organizations for Economic Co-operation and Development), the Developing Countries cannot catch up with more developed countries, unless Developing Countries can gain access to the new technology. The three most common channels of technology transfer include: (1) foreign direct investment; (2) international licensing agreements; and (3) international trade.

A growing number of studies have found a statistical relationship between FDI inflows and economic growth in the host countries.

Applying a model of endogenous economic growth, it is found that FDI stimulated the long-term expansion of per capita GDP. The contribution of FDI is likely to come from two effects. The more important one seems to be that the productivity of FDI is higher than that of domestic investment. This is because FDI promotes transmission of foreign advanced technology and management skills into the host economies, generates factors that can stimulate the host country's economic efficiency and competition, and provides the host economies with increased access to world markets. However, it appears that the higher productivity occurs only when the host country has a minimum threshold stock of human capital, because there is an essential interaction between FDI/advanced technology and human capital in the host economy. The second consequence explains that FDI has the effect of increasing total domestic investment by more than one-for-one.

Foreign Direct Investment (FDI) is fund flow between the countries in the form of inflow or outflow by which one can able to gain some benefit from their investment whereas another can exploit the opportunity to enhance the productivity and find out better position through performance. The effectiveness and efficiency depends upon the investors perception, if investment with the purpose of long term then it is contributes positively towards economy on the other hand if it is for short term for the purpose of making profit then it may be less significant. Depending on the industry sector and type of business, a foreign direct investment may be an attractive and viable option. Any decision on investing is thus a combination of an assessment of internal resources, competitiveness, and market analysis and market expectations. The FDI may also affect due to the government trade barriers and policies for the foreign investments and leads to less or more effective towards contribution in economy as well as GDP of the economy. The studies try to find out the implications which affect the economic scenario and also measure the level of predominance by

the factors for economic contribution to India.

The growth of FDI gives opportunities to Indian industry for technological up gradation, gaining access to global managerial skills and practices, optimizing utilization of human and natural resources and competing internationally with higher efficiency.

## **REASONS FOR FDI**

As explained earlier, FDI is the ownership and control over assets held in foreign countries. There are a number of reasons for FDI. These reasons include: increase in sales and profits, enter rapidly growing markets, reduce costs, consolidate trade blocs, protect domestic markets, protect foreign markets, and acquire technological and managerial know-how. Now, we shall discuss these reasons.

### **To Increase Sales And Profits:**

Companies invest capital directly in various foreign countries in order to increase sales and profits. This is because foreign markets offer more attractive opportunities for business than domestic markets. For example, Mitsubishi, Toyota and Mercedes increased their sales in the USA, whereas General Motors, Ford and Chrysler increased their sales in Europe. Coca-Cola has been earning more profits in foreign countries than in the USA.

### **To Enter Fast Growing Markets:**

Some international markets grow at a fast rate than other markets. The fast growing markets provide better opportunity to MNC for their business growth. IBM entered Japan laptop market through FDI during the earlier 1990s as the Japanese laptop market had grown by 40 per cent during that period.

### **To Reduce Costs:**

MNCs invest in foreign countries with view to reduce cost of production and various other operations. This is due to the availability of various inputs like raw material, human resources etc., at lower price in foreign countries. Some of the software companies invested in India due to lower human resource costs in India. Similarly, domestic companies invest in foreign markets due to lower transportation costs and energy costs, Japanese steel firms moved to the USA due to lower transportation. The US firms moved to Mexico, South Korea, Taiwan, Hong Kong, India, China etc., in order to utilize the opportunity of lower costs.

### **To Consolidate Trade Blocs:**

MNCs prefer to do business with other member countries of the trade bloc. This is because the MNCs get preferential treatment in doing business.

### **To Protect Domestic Markets:**

Some MNCs invest and operate in foreign markets with a view to avoid the competition with the weak domestic firms. In other words, they leave the domestic market to the less competitive domestic firms.

**To Protect Foreign Markets:**

Some MCs invest in foreign countries in order to protect foreign markets. British Petroleum invested in the USA and protected the declining service stations.

**To Acquire Technological and Managerial Know-How:**

Sometimes the technological and managerial know – how in various foreign countries might be superior to those of domestic country. In such cases MNCs invest in foreign countries in order to acquire the superior foreign technological and managerial know-how. For example, the US companies acquired the technological as well as managerial know – how from Japan by investing in Japan. Kodak established the world class research facilities in Japan.

**COSTS AND BENEFITS OF FDI**

FDI has its costs and benefits to the home country as well as host country. Now, we shall discuss the costs and benefits of FDI to home country.

**Benefits To Home Country**

Inflow of foreign currencies in the form of dividend, interests etc. Nissan's profits repatriated to Japan are from its FDI in the UK. They helped Japan for positive balance of payments. FDI increases export of machinery, equipment, technology etc. from the home country to the host country. This in turn enhances the industrial activity of the home country. The increased industrial activity in the home country enhances employment opportunities. The firm and other home country firms can learn skills from its exposure to the host country and transfer those skills to the industry in the home country.

**\_Costs To Home Country**

There are costs to the home country, in addition to benefits form the FDI. They include:

Home country's industry and employment position are at stake when the firms enter foreign markets due to low cost labour. The US textiles moved to Central America. This resulted in retrenchment in USA. Current account position of the home country suffers as FDI is a substitute for direct exports.

**BENEFITS TO HOST COUNTRY****Resource-Transfer Effects:**

The resources which are scarce in host country are transferred from the foreign country. These resources include foreign capital, technology, machinery and equipment, management and organization. Transfers of these resources develop the host country economically and socially. Indian government has been encouraging the FDI after 1991 to develop the Indian industry, infrastructure and service sectors.

**Employment Effects:**

The FDI contributes for the establishment of new industries and business directly and for the employment of existing economic activity. Further, FDI helps for the developing of ancillary industries. These

developments invariably increase the employment opportunities for the people of the host country.

### **Balance of Payments Effects:**

Balance of payments position and foreign exchange resources are very crucial from the view point of external situation of country. India faced severe foreign exchange resource crunch and thereby unfavourable balance of payments position before July 1991. In fact this adverse position forced the Indian government to announce economic liberalization in July 1991. FDI provides capital for the production of a number of goods and services domestically. This in turn reduces the imports and thereby improves the current account position of the host country's balance of payment. Further, the foreign companies export the goods, produced in the host country to a number of other countries. This activity helps the host country to have foreign exchange earnings. For example, Nissan established its plants in the UK and exports 80% of its automobiles to other countries and improved Britain's balance of payments.

### **CONCLUSION AND SUGGESTIONS:**

The Indian government policy towards FDI has changed over time in tune with the changing developmental needs in different phases of development. India opened up the economy in the early nineties following a major crisis of foreign exchange. The response was a slew of domestic and external sector policy measures partly prompted by the immediate needs and partly by the demand of the multilateral organisations. The new policy regime radically pushed forward in favour of a more open and market-oriented economy.

Globalisation and liberalisation of financial markets bring a variety of changes, presenting opportunities as well as risks both in economies and financial systems throughout the world. Globalisation is defined as more integrated financial markets, economies and trade, higher factor mobility, and spectacular change in information technology leading to the spread of knowledge throughout the world.

Developing countries have made their presence felt in the economies of developed nations by receiving a descent amount of FDI in the last three decades. Although India is not the most preferred destination of global FDI, there has been a generous flow of FDI in India since 1991. It has become the 2nd fastest growing economy of the world.

- ❖ Growth in FDI inflows to India seems to be fairly satisfactory but India's share in the global FDI is still minuscule. This calls for further liberalisation of norms for investment by policy makers. It underlines the need for efficient and adequate infrastructure, availability of skilled and semiskilled labour force, business friendly public administration and moderate tax rates.
- ❖ The locational strategies chosen by firms are likely to be highly contextual and would vary according to industry specific characteristics, the motives for FDI, and the functions being performed by MNC subsidiaries. The government should recognise that the location specific advantages are sought by investors. Over all, India needs to maintain the growth momentum and to

make better use of their abundant labour forces and it has to follow more open trade policies for attracting FDI.

- ❖ The actions of the government need to focus on controlling inflation at reasonable levels, enhancing per capita income and ensuring the investments turned into gross fixed capital assets which lead to attract more FDI into India.
- ❖ The government needs to give focussed attention to the upgrading and reconfiguring of their own unique location bound advantages with specific reasons, both actual and potential. For example Mumbai region and then national capital region accounts for 55.56% of total investments received during the last 10 years. Hence, regional initiatives need to be designed carefully to ensure the benefits spread across all the regions and sectors.
- ❖ It is possible that government regulations and policies may deter some forms of FDI, particularly where they affect ownership. Thus the Government needs to assess the benefits of such interventions against the costs of creating impediments to FDI.
- ❖ Policy makers have to maintain the same level playing field for both foreign investors and domestic investors while formulating policy measures.
- ❖ The measures must be initiated by policy makers to create specific location advantages in areas and sectors which have not been able to attract more FDI. This will help reduce the disparities in development across regions and sectors.
- ❖ India has registered trade deficit with countries like Korea, Japan etc. out of the selected countries for this analysis. It was observed that electronic and automobile components were imported from these countries to India. Hence concerted effort must be made by the policy makers to improve the performance of these industries to reduce the trade deficit.
- ❖ India has a positive trade with countries like USA, UAE but the trade gap is gradually reducing. India was unable to maintain the same share of exports to USA out of its total exports over the last decade. Since USA is a very important market, India should initiate steps to improve its share without losing to other developing countries.
- ❖ Even though India is having double taxation treaties with countries such as Mauritius, Cyprus etc., there is a gradual decline in FDI flows from those countries since 2008-09. Hence, the Indian government has to revisit the policy of double taxation treaty entered with Mauritius two decades ago.
- ❖ Government of India must not change policies too frequently and has to maintain policy framework for at least considerable time period. This will enable the foreign investors to plan their strategy well in advance and it also gives them some sense of certainty. Any modification in tax system must be prospective in nature and it should not indulge in taxing retrospectively.

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