IFSMRC AIJRM *Volume-03* *Issue-05* *Jan-Jun 2015*
Online ISSN: 2308 1341
Print ISSN : 2308 3034
www.ifsmrc.org

A Review of Foreign Investment Flows and Policies in India

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Abstract

In this an article, authors would like to focus on Foreign Investment in India. Foreign Direct Investment (FDI) to India remained sluggish when global FDI flows to emerging market economics had recovered in 2013-15. A perusal of India's FDI policy vis-à-vis other major Emerging Market Economies (EMEs) reveals that though India's approach towards foreign investment has been relatively conservative to begin with, it progressively started catching up with the more liberalized policy stance of other EME's from the early 1990s onwards, inter alia in terms of wider access to different sectors of the economy, ease of starting business, repatriation of dividend and profits and relaxations regarding norms for owing equity.

Keywords: *FDI- EMEs- India- progressively- business- dividend*

Introduction

This progressive liberalization, coupled with considerable improvement in terms of macroeconomic fundamentals, reflected in growing size of FDI flows to the country that increased nearly 5 fold during first decade of the present millennium.

Though liberal policy stance and strong economic fundamentals appear to have driven the steep raise in FDI flows in India over past one decade and sustained their momentum even during the period of global economic crisis, the subsequent moderation in investment flows despite faster recovery from the crisis period appears somewhat inexplicable. Survey of empirical literature and analysis presented in the paper seems to suggest that these divergent trends in FDI flows could be the result of certain institutional factors that dampened the investor's sentiments despite continued strength of economic fundamentals.

This paper has been organized as follows. Section 1 Presents trends in global investment flows with particular focus on EMES and India. Section 2 traces the evolution of India's FDI policy framework, followed by cross-country experience reflecting on India's FDI policy framework, followed by cross country experience reflecting on India's FDI policy vis-à-vis that of select EME's.

Section 1: Trends in FDI inflows

Widening growth differential across economies and gradual opening up of capital accounts in the emerging world resulted in a steep rise in cross border investment flows during the past two decades. This section briefly presents the recent trends in global capital flows particularly to emerging economies including India.

1.1 Global trends in FDI flows:

During the period subsequent to dotcom burst, there has been an unprecedented rise in the cross-border flows and this exuberance was sustained until the occurrence of global financial crisis in the year 2008-09. Between 2003 and 2007, global FDI flows grew nearly four-fold and flows to EME's during this period, grew by about three-fold. After reaching a peak of US $2.1 trillion in 2007, global FDI flows witnessed significant moderation over the next two years to touch US $ 2.1 trillion in 2009, following the global financial crisis.

Online ISSN: 2308 1341
Print ISSN : 2308 3034
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On the other hand, FDI flows to developing countries increased from US $ 565 billion in 2007 to US $ 630 billion in 2008 before moderating to US $ 478 billion in 2009.

In the EME's in Asia, China is forecast to be the fastest growing economy amongst all EME's with an expected real GDP growth of 7.1% in 2015, followed by India (6.6%), Vietnam (5.6%), the Phillipines (5.6%) and Indonesia (5.4%). India's economy is expected to see most macroeconomic improvements in 2015 with lower inflation and a reduction in its current account deficit. Ukraine and Russia are projected to be the slowest growing economies, with GDP contraction of 4% and 3.8%.

Geopolitical crisis and political instability will pose downside risks for some EME's. The Russia-Ukraine crisis and the European Union (EU) sanctions on Russia have affected the economic performance of not only Russia and Ukraine but also other eastern European emerging countries. The uprising of Islamic state extremists in Syria and Iraq and political instability in Libya will adversely affect the business environment of emerging markets in the Middle East and Africa region.

India will have a bright spot among EME's if necessary reforms are undertaken, as real GDP growth has been forecasted to accelerate to 6.6% in 2015 from 5.4% in 2014. Lower oil prices will reduce inflationary pressures and helps to improve the current account deficit, while offering the Indian government a good chance to cut down its expensive fuel subsidies.

The decline in global FDI during 2009 was mainly attributed to subdued cross border Merger and Acquisition (M&A) activities and weaker return prospects for foreign affiliates, which adversely impacted equity investments as well as reinvested earnings. According to UNCTAD, decline in M&A activities occurred as the turmoil in stock markets obscured the price signals upon which M&A's rely. There was a decline in the number of green field investment cases as well as particularly those related to business and financial services.From an institutional perspective, FDI by private equity funds declined as their fund dropped on the back of investors risk aversion and the collapse of the leveraged buyout market in tune with the deterioration in credit market conditions. On the other hand, FDI from sovereign wealth funds rose by 15% in 2009. FDI flows into select countries are given below in Table 1

Table 1: FDI inflows in select countries from 2012 to 2013

Countries	Amount (US $ billions)			Growth rate
	2012 H1	2012 H2	2013 H1	
Argentina	7.6	4.7	6.1	-33.1
Brazil	29.7	36.5	30.0	1.0
Saudi Arabia	6.2	6.0	5.8	-6.5
China	59.1	52.6	67	13.4
India	10.1	15.2	13.6	34.7
Philippines	2.0	0.8	2.2	10.9
Singapore	28.1	28.6	25.9	-7.9

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Print ISSN : 2308 3034
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Thailand	4.2	3.1	1.9	-53.5
Russia	17.2	34.2	56	225.1
France	16.2	8.8	4.3	-73.3
U.S.A	84.4	76.2	66.3	-21.5
Germany	10.4	-3.6	0.9	-91.1
Switzerland	9.7	-8.3	7.0	---

1.2: Trends in FDI inflows to India:

With the tripling of FDI inflows in EMEs during the pre-crisis period of the 2000, India also received large amount of FDI inflows in line with its robust domestic economic performance. The attractiveness of India as a preferred investment destination could be ascertained from the large increase in FDI inflows to India, which rose from around US $ 6 billion in 2001-02 to US $ 34.7 billion in 2013. The significant increase in FDI inflows to India reflected the impact of liberalization of the economy since the early 1990s as well as gradual opening up of the capital account. As part of the capital account liberalization, FDI was gradually allowed in almost all sectors, except a few on grounds of strategic importance, subject to compliance of sector specific rules and regulations. The large and stable FDI flows also increasingly financed the current account deficit over the period. During the recent global crisis, when there was a significant dicrease in global FDI flows during 2009-10, the decline in FDI flows to India was relatively insignificant and reflecting robust equity flows on the back of strong rebound in domestic growth ahead of global recovery and steady reinvested earnings reflecting the possibility of better companies in India.

Investing in India increased to US $ 5502 million in January 2015 from US $ 3968 million in December 2014. FDI in India averaged US $1048.39 million from 1995 until 2015, reaching an all time high of US $ 5670 million in February of 2008 and a record low of US $ 60 million in February of 2014.

With the tripling of the FDI flows to EMEs during the pre-crisis period of the 2000, India also received large FDI inflows in line with its robust domestic economic performance. The attractiveness of India as a preferred investment destination could be ascertained from the large increase in FDI inflows to India, which rose from around US $ 6 billion in 2001-02 to almost US $ 38 billion in 2008-09. The significant increase in FDI inflows to India reflected the impact of liberalisation of the economy since the early 1990s as well as gradual opening up of the capital account. As part of the capital account liberalisation, FDI was gradually allowed in almost all sectors, except a few on grounds of strategic importance, subject to compliance of sector specific rules and regulations. The large and stable FDI flows also increasingly financed the current account deficit over the period. During the recent global crisis, when there was a Significant deceleration in global FDI flows during 2009-10, the decline in FDI flows to India was relatively moderate reflecting robust equity flows on the back of strong rebound in domestic growth ahead of global recovery and steady reinvested earnings (with a share of almost 25 per cent) reflecting better profitability of foreign companies in India. However, when there had been some recovery in global FDI flows, especially driven by flows to Asian EMEs, during 2010-11, gross FDI equity inflows to India witnessed significant moderation. Gross equity FDI flows to India moderated to US $ 20.3 billion during 2010-11 from US $ 27.1 billion in the preceding year.

Table 2 - Equity FDI inflows to India
(Amount in US $ millions)

Sector	2012-13 (April-March	2013-14 (April-March	2014-15 (April 14-March	Cumulative Inflows April, 2000-March,201	% of total inflows

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	)	)	15)	5	
Service Sector	26,306	13,294	19,963	205,532	17 %
Construction and development	7,248	7,508	4,582	113,140	10 %
Telecommunication	1,654	7,987	17,372	84,092	7%
Computer Hardware and Software	2,656	6,896	13,564	73,235	6%
Drugs and Pharmaceuticals	6,011	7,191	9,211	65,282	5%
Automobile Industry	8,384	9,027	15,794	63,991	5%
Chemicals	1,596	4,738	4,077	49,310	4%
Power	2,923	6,519	3,985	46,640	4%
Metallurgical Industries	7,878	3,436	2,897	41,147	3%
Trading	3,901	8,191	16,962	43,799	3%

From a sectoral perspective, FDI in India mainly flowed into services sector (with an average share of 41 per cent in the past five years) followed by manufacturing (around 23 per cent) and mainly routed through Mauritius (with an average share of 43 per cent in the past five years) followed by Singapore (around 11 per cent). However, the share of services declined over the years from almost 57 per cent in 2006-07 to about 30 per cent in 2010-11, while the shares of manufacturing, and 'others' largely comprising 'electricity and other power generation' increased over the same period (Table 2). Sectoral information on the recent trends in FDI flows to India show that the moderation in gross equity FDI flows during 2010-11 has been mainly driven by sectors such as 'construction, real estate and mining' and services such as 'business and financial services'. Manufacturing, which has been the largest recipient of FDI in India, has also witnessed some moderation.

Section 2: FDI policy framework

Policy regime is one of the key factors driving investment flows to a country. Apart from underlying macro fundamentals ability of a nation to attract foreign investment essentially depends upon its policy regime – whether it promotes or restrains the foreign investments flows. This section undertakes a review of India's FDI policy framework and makes a comparison of India's policy vis-à-vis that of select EME's.

2.1 FDI policy framework in India

There has been a sea change in India's approach to foreign investment from the early 1990s when it began structural economic reforms encompassing almost all the sectors of the economy.

Pre-liberalization period

Historically, India had followed an extremely cautious and selective approach while formulating FDI policy in view of the dominance of import substitution strategy of industrialization. With the objective of becoming 'self reliant' there was a dual nature of policy intention – FDI through foreign collaboration was welcomed in the areas of high technology and high priorities to build national capability and discouraging in low technology areas to protect and nurture domestic industries. The regulatory framework was consolidated through the enactment of Foreign Exchange Regulation Act (FERA), 1973 where in foreign equity holding in a joint venture was allowed only up to 40%. Moreover, drawing from successes of other country experience in Asia, Government not only established Special Economic Zones (SEZ's) but also designed liberal policy and provided incentives for promoting FDI in these zones

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with a view to promote exports. As India continues to be highly protective, these measures did not add substantially to export competitiveness. Recognizing these limitations, partial liberalization in the trade and investment policy was introduced in the 1980's with the objective of enhancing export competitiveness, modernization and marketing of exports through trans-national corporations (TNCs). The announcements of industrial policy (1980 and 1982) and technology policy (1983) provided for liberal attitude towards foreign investments in terms of changes in policy directions. The policy was characterized by de-licensing of some of the industrial rules and promotion of Indian manufacturing exports as well as emphasizing on modernization of industries through liberalized imports of capital goods and technology. This was supported by trade liberalization in the form of tariff reduction and shifting of large number of items from import licensing to Open General Licensing (OGL).

A major shift occurred when India embarked upon economic liberalization and reforms program in 1991 aiming to raise its growth potential and integrating with the world economy. Industrial policy reforms gradually removed restrictions on investment projects and business expansion of the one hand and allowed increases access to foreign technology and funding on the other. A series of measures that were directed towards liberalizing foreign investment included: (i) Introduction of dual route approval of FDI – RBI's automatic route and governments approval (SIA/FIPB) route (ii) Automatic permission of technology agreements in high priority industries and removal of restriction of FDI in low technology areas as well as liberalization of technology imports, (III) Permission of nonresident Indians and overseas corporate bodies to invest upto 100% in high priority sectors (iv) hike in the foreign equity participation limits to 51% for existing companies and liberalization of the use of foreign brands name and (v) Signing of convention of Multilateral Investment Guarantee (MIGA) for protection of foreign investments. These efforts were boosted by the enactment of Foreign Exchange Management Act (FEMA), 1999 that replaced the Foreign Exchange Regulation Act (FERA), 1973 which was less stringent. This along with the sequential financial sector reforms paved way for greater capital account liberalization in India.

Investment proposals failing under the automatic route and matters related to FEMA is dealt with by RBI. While the government handles investment through approval route and issues that related to FDI policy per se through its three institutions, viz the Foreign Investment Promotion Board (FIPB), the Secretariat for Industrial Assistance (SIA) and the Foreign Investment Implementation Authority (FIA).

FDI under the automatic route does not require any prior approval either by the government or the reserve bank. The investors are only required to notify the concerned regional office of the RBI within 30 days of issuance of shares to foreign investors. Under the approval route, the proposals are considered in a time bound and transparent manner by the FIPB. Approvals of composite proposals involving foreign investment/foreign technical collaboration are also granted on the recommendations of the FIPB. Current FDI policy in terms of sector specific limits has been summarized in the following table

2.2 FDI policy: The international experience

Foreign direct investment is treated as an important mechanism for channelizing transfer of capital and technology and thus perceived to be a potent factor in promoting economic growth in the host countries. Moreover, multinational corporations consider FDI as an important means of reorganize their production activities across borders in accordance with their corporate strategies and the competitive advantage of host countries. These considerations have been the key motivating elements in the evolution and attitude of EMEs towards investment flows from abroad in the past few decades particularly since eighties. This section reviews the FDI policies of select

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Print ISSN : 2308 3034
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countries to gather some perspective as to "where does India stand" at the current juncture to draw policy imperative for FDI policy in India.

China

1. Encouragement to FDI has been an integral part of the china's economic reform process. It has gradually opened up its economy for foreign businesses and has attracted large amount of direct foreign investment.
2. Government policies were characterized by setting new regulations to permit joint ventures using foreign capital and selling up Special Economic Zones (SEZs) and open cities. The concept of SEZs was extended to fourteen more coastal cities in 1984. Favorable regulations and provisions were used to encourage FDI inflow, especially export-oriented joint ventures using advanced technologies in 1986.
3. Foreign joint ventures were provided with preferential tax treatment, the freedom to import inputs such as materials and equipment, the right to retain and swap foreign exchange with each other, and simpler licensing procedures in 1986. Additional tax benefits were offered to export-oriented joint ventures and those employing advanced technology
4. Priority was given to FDI in the agriculture, energy, transportation, telecommunications, basic raw materials, and high technology industries and FDI projects which could take advantage of the rich natural resources and relatively low labor costs in the central and northwest regions.
5. Chinas policies toward FDI have experienced roughly three stages: gradual and limited opening, active promoting through preferential treatment, and promoting FDI in accordance with domestic industrial objectives. These changes in policy priorities inevitably affected the pattern of FDI inflows in china.

a. Korea

6. The Korean government maintaining distinctive foreign investment policies giving preference to loans over direct investment to supplement its low level of domestic savings during the early stage of industrialization. Korea's heavy reliance on foreign borrowing to finance its investment requirements is in sharp contrast to other countries.
7. The Korean government had emphasized the need to enhance absorptive capacity as well as the indigenization of foreign technology through reverse engineering at the outset of industrialization while restricting both FDI and foreign licensing. This facilitated Korean firms to assimilate imported technology, which eventually led to emergence of global brands like Samsung, Hyundai and LG.
8. The Korean government pursued liberalized FDI policy in the aftermath of the Asian financial crisis in 1997-98 to fulfill the conditionality of the International Monetary Fund (IMF) in exchange for standby credit.
9. Several new institutions came into being in Korea immediately after the crisis. Invest korea is koreas national investment promotion agency mandated to offer one stop service as a means of attracting foreign direct investment, while the office of the investment Ombudsman was established to provide investment after care services to foreign invested companies in korea. These are affiliated to the Korea Trade

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Print ISSN : 2308 3034
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Investment Promotion Agency (KTIPA).

10. Korea enacted a new Foreign Investment Promotion Act in 1998 to provide incentives to foreign investors which include tax exemptions and reductions, financial support for employment and training, cash grants for R&D projects and exemptions or reductions of leasing costs for land, factory and business operations for a specific period.
11. One of the central reasons for the delays in the construction process in Korea is said to be the lengthy environmental and cultural due diligence on proposed industrial park sites (OECD, 2008).

To sum up, the spectacular performance of china in attracting large amount of FDI could be attributed to its proactive FDI policy comprising the setting up of SEZ's particular exports catering to the international market, focus on infrastructure and comparative advantage owing to the low labour costs. A comparison of the FDI policies pursued by select emerging economies, set out above, suggests that policies although broadly common in terms of objective, regulatory framework and focus on technological up gradation and export promotion, the use of incentive structure and restrictions on certain sectors, has varied across countries. While china and Korea extend explicit tax incentives to foreign investors, other countries focus on stability and transparency of tax laws. Similarly while all the countries promote investment in manufacturing and service sector, china stands out with its relaxation for agriculture sector as well. However, It is appearing that though policies across countries vary in specific, there is a common element of incentivsation of foreign investment.

Table 3: **Incentivisation of foreign investment**

	Year of liberalization	Objective	Incentives	Priority sectors	Unique features
China	1979	Transformation of traditional agriculture, promotion of industrialization, infrastructure and export promotion.	Foreign joint ventures were provided with preferential tax treatment. Additional tax benefits to export oriented joint ventures and those employing advanced technology.	Agriculture energy, t transportationtelecommunication, basic raw materials, and high technology industries	Setting up of special economic zones

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Print ISSN : 2308 3034
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Korea	1998	Promotion of absorptive capacity and indigenization of foreign technology through reverse engineering at the outset of industrialization while restricting both FDI and Foreign licensing.	Businesses located in foreign investment zone enjoy full exemption of corporate income tax for five years from the year in which the initial profit is made and 50 percent reduction for the subsequent two years. High tech foreign investments in the free economic zones are eligible for the full exemption three years and 50% for the following two years.		

2.3Cross-country comparison of FDI policies – where does India stands?
FDI policy in India

In the pre-liberalization period, India had followed an extremely cautious and selective approach while formulating FDI policy. The historical background of FDI in India can be traced back with the establishment of East India Company of Britain. British capital came to India during the colonial era. Before indepen dence, major FDI came from the British companies. After Second World War, Japanese companies entered in the Indian Market. Since independence, issues relating to foreign capital, MNCs, gained attention of policy makers. The industrial policy of 1965, allowed MNCs to venture through technical collaboration in India. The govt. has provided many incentives such as tax concessions, simplified licensing etc to boost the FDI inflows. In fact, in the early nineties, Indian economy faced severe balance of payment crisis. India was left with that much amount of foreign exchange reserves which can finance its three weeks of imports. In this critical face of Indian economy, economic reforms were made in 1991 and India opened its doors for FDI inflows and adopted a more liberal foreign policy to restore the confidence of foreign investors (Sapana Honda 2011). A series of measures that were directed towards liberalizing foreign investment included the followingig. Introducing the duel route of approval of FDI: RBI's automatic route and Governments approval route through Foreign Investment Promotion Board (FIPB) and Secretariat for Industrial Assistance (SIA)
ii) Automatic permission for technology agreements in high priority industries and liberalization of technology imports
iii) Permission to NRIs and Overseas Corporate Bodies to invest up to 100% in high priority sectors.
iv) Hike in the foreign equity holding limits to 51% and liberalization of the use of foreign brands and their names.
v) Signing of the convention of multilateral investment guarantee agency for protection of foreign investments.
vi) These efforts were boosted by the enactment of Foreign Exchange Management Act. 1999, that replaced the Foreign Exchange Regulation Act. 1973. This along with the sequential financial sector reforms

paved way for greater capital account liberalization in India. GOI announced significant measures like 100% FDI in business to business (B2B), airports, e-commerce, power sector, oil refining. Manufacturing activities in all SEZs canhave 100% Automatic route except for arms, explosives, allied defence equipments, narcotics etc.

Following key observations could be made from this comparison

1. A comparative analysis among the select countries reveals that countries such as China and Korea have sectoral caps higher than those of India implying that their FDI policy is more liberal.
2. The sectoral caps are lower in china than in India in most of the sectors barring agriculture and forestry and insurance. A noteworthy aspect is that china permits 100% FDI in agriculture while completely FDI in media. The sectoral caps in India are shown below.

Table 4: Sectoral Cap in India

Sector	% of FDI CAP	Entry route
Agriculture and Animal Husbandry	100	Automatic
Tea Plantations	100	Government
Mining	100	Automatic/Government
Defense	26	Government
Power	100	Automatic
Civil Aviation Sector	Varies for different particulars within the sector	-
Banking Private Sector	74	Automatic-till 49% Government-from 49% to 74%
Banking Public Sector	20	Government
Infrastructure	100	Automatic
Insurance	26	Automatic
Print Media	26 100 (For publication of scientific journals)	Government
Satellites	74	Government
Telecommunication	74	Automatic-till 49% Government-from 49% to 74%

India positioned well vis-a-vis comparable counterparts in the select countries in terms of the indicator ‘starting a foreign business’. In 2009, starting a foreign business took around 46 days with 16 procedures in India as compared with 99 days with 18 procedures in China and 166 days with 17 procedures in Brazil In terms of another key indicator, viz., ‘accessing industrial land’ India’s position is mixed. While the ranking in terms of indices based on lease rights and ownership rights is quite high, the time to lease private and public land is one of the highest among select countries at 90 days and 295 days, respectively. In China, it takes 59 days to lease private land and 129 days to lease public land. This also has important bearing on the investment decisions by foreign companies.

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