

**CHAPTER 7**

**SUMMARY,**

**RECOMMENDATIONS AND**

**CONCLUSIONS**

The reforms undertaken since 1991 in India have unleashed the potential growth of the economy and stimulated international trade with its linkages to inward and outward FDI. Changes have been so many that investors have started to take a new look at India. At the same time, some Indian firms have become global players. In this study various dimensions of FDI were incorporated into a theory of "open economy development", so as to explain, in one integrated theoretical and empirical paradigm, the undercurrents of both inward and outward FDI flows. It was particularly interesting to do a parallel study of the evolution of Indian FDI inflows and outflows, which helped to assess the nature and the true extent of globalisation of the Indian economy.

In different chapters, the trends and patterns of inward and outward FDI were examined and analysed along with an empirical study of their determinants. The broad findings and conclusions along with suitable recommendations and limitations are summarised in this chapter under the headings of "Inward FDI" and "Outward FDI".

## **SECTION 7.1**

### **INWARD FDI IN INDIA**

India is growing at an average growth rate of close to 6 percent a year since 1980, with some evidence that growth is accelerating and can be sustained at 8 percent a year in the coming decades. With population of 1.1 billion in 2003, India presents a huge and fast growing domestic market for a range of goods and services, and thus export opportunities for producers in the rest of the world. Large and growing market opportunities in India are widely seen, as evidenced by the large flows of foreign direct investment, attractive both for production for the domestic market, and also to use exports to the rest of the World.

Inward FDI has boomed in post-reform India. The Indian government policy towards FDI has changed over time in tune with the changing developmental needs in different phases of development. The changing policy framework has affected the trends and patterns of FDI inflows received by the country. At the same time, the composition and type of FDI has changed considerably. Even though manufacturing industries have attracted rising FDI, the services sector accounted for a steeply rising share of FDI stocks in India since the mid-nineties. Thus, although the magnitude of FDI inflows has increased, in the absence of policy direction, the bulk of them have gone into services and soft technology consumer goods industries bringing the share of manufacturing and technology intensive among them down. In terms of investing countries, it can be noted that there is a high degree of concentration with more than 50 percent of the investment coming from Mauritius, U.S and Japan. Also, while FDI in India continues to be local "market seeking" in the first place, its world-market orientation has clearly increased in the aftermath of economic reforms. Thus while

the growth of FDI inflows to India seem to be fairly satisfactory; India's share in the global FDI regime is still minuscule. This calls for further liberalisation of norms for investment by present and prospective investors. It underlines the need for efficient and adequate infrastructure, availability of skilled and semiskilled labour force, business friendly public administration and moderate tax rates.

Opening up the Indian economy and the resulting FDI flows have really created new opportunities for India's development and boosted the performances of local firms as well as the globalisation of some of them. Such a trend has undeniably raised Indian's stature among developing countries. However, the potential of the country to catch up the levels of the leading economies in the coming decades, often touched on, is not quite guaranteed. India has an extremely hard job to perpetuate its advantages, to achieve further productivity gains and to ensure that all segments of its population participate in the income growth.

The findings of the empirical study on determinants of inward FDI are consistent with the trend and patterns of inward FDI flows.

Over a period of time general and specific FDI policies have become less restrictive to inward FDI in India. With fewer policy barriers, other factors have become emerged as important determinants. 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.

Market size is an important factor affecting FDI, however, in India this important traditional variable has decreased in importance. At the same time, cost differences between locations, spillovers from increased competition on the domestic turf, the ease of doing business and the availability of skills have become more important. This is validated in the results of this study.

Thus although FDI remains strongly driven by its traditional determinants, the relative importance of different Locational determinants for competitiveness enhancing FDI is shifting. Cheap and skilled labour is an important determinant attracting FDI to India. A high wage adjusted productivity of labour has attracted "efficiency seeking" FDI aiming to produce for the domestic economy as well as for exports to other countries. India remains a country with a large supply of skilled human capital attracting more FDI, particularly in sectors that are relatively intensive in the use of skilled labour. While low cost remains a Locational advantage, the increasingly sought after advantages are competitive combinations of wage, skills and productivity. This explains the growing volume of vertical "efficiency seeking" FDI in which foreign companies seek to produce intermediate and / or final products in the cheapest (real) cost locations primarily for exports to third markets. It is found that the FDI flows were already skewed towards manufacturing and services sector in 1990, but increasingly have shifted towards services in the past fifteen years. India has been able to attract increasing amounts of FDI in high value-added services. Now, even the most strategic of functions such as R&D are expanding in some developing countries as multinational corporations seek to benefit from pools of talent at competitive costs, particularly in those countries that have actively helped to create this (incl. Singapore, Malaysia, China and India).

This has implications on the success of domestic policies to attract inward FDI. The nature and sequencing of general and specific policies in areas covering investment,

trade, innovation and human resources are all important. Appropriate policies to benefit from FDI include building up local human resource and technological capabilities to capture productivity spillovers. FDI location decisions will increasingly depend on economic factors and not on temporary policy interventions.

One important hypothesis from various studies is that gains from FDI are far higher in an open regime. Trade openness generally positively influences the export oriented FDI inflow into the economy. As shown in our results trade openness in the Indian economy has emerged as an important factor attracting FDI inflows.

The results also suggest that long term investment benefits from stability as it reduces the risks for the long-term investor. This is backed up by investor surveys and to a large extent by the evidence. Politically unstable countries tend to receive relatively small amounts of FDI. Government finance is another important issue that affects capital flows. A high level of external debt in India has emerged as a deterrent for FDI inflows.

To conclude, 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 sought by mobile investors are changing. Over all, India needs to maintain the growth momentum to improve market size, frame policies to make better use of their abundant labour forces and follow more open trade policies for attracting FDI. Field surveys of the rankings of various countries by business executives, compiled and published by the EIU in the 2000 and 2001 editions of the *World Investment Prospects*, show that business executives are increasingly ranking the political stability, quality of infrastructure and government policies towards private enterprise and competition, along with the

macro economic environment, as the critical variables likely to affect the future geography of FDI in the early years of the 21st century. The government needs to give constant attention to the upgrading and reconfiguring of their own unique location bound advantages, both actual and potential. However, regional initiatives need to be designed carefully to ensure the benefits of new FDI are broadly spread across 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, which reduce the ability of the country to compete with other developing countries for foreign investments.

Many of the motivations influencing the investment decisions of multinational companies apply equally to domestic investors. Addressing the problems identified by foreign investors already committed to the region should not only in the long run make India more attractive to new FDI but should in the shorter term encourage increased domestic investment.

If the economy has to benefit from the FDI's spillover effects and economic growth, the country needs to attract FDI formulating a bundle of policies that caters for the interests of all the potential investors from different countries. This implies that the country needs stable macro economic indicators, better country risk profile followed by cost related and investment environment improving factors.

Thus India should continue its program of economic reforms, as a sustained healthy economic growth is the biggest attraction for foreign capital. However, any political reforms need to ensure that instability does not ensue. Further, the government

should create specific location advantages in areas and sectors which have not been able to attract more FDI, such as skilled employees and improving the infrastructure. This will help reduce the disparities in development across regions and sectors.

### **Limitations**

Like all research, the findings here need to be interpreted cautiously given the inherent data constraints of the macro economic time series data and the scope of this research. It is possible that the importance of the locational factors will differ depending on sector, type and motivation of FDI and a more detailed study at the micro level would yield meaningful insights.

### **Scope for Further Research**

An interesting topic for future research would be to analyse how foreign direct investment in India is affected by factor endowments such as knowledge capital, in order to better explain the driving forces of FDI and more closely determine whether FDI tends to be vertical rather than horizontal in nature. It would also be very pertinent to study the impact of FDI inflows on various macro and micro economic variables. Another interesting research avenue would be to undertake a causal analysis to determine whether the relationship between FDI and growth is unidirectional or bidirectional.



## **SECTION 7.2**

### **OUTWARD FDI FROM INDIA**

OFDI from India has increased appreciably over the past decade following the reforms and liberalisation of policies undertaken by the Government since 1991. OFDI has emerged as an important mechanism through which the Indian economy is integrated with the global economy, along with growing trade and inward FDI. The OFDI behaviour of Indian firms in the earlier periods of seventies and eighties was found to be restricted to a small group of large-sized family-owned business houses investing mostly in a selected group of developing countries. The restrictive government policies on firm's growth followed in India seems to have pushed these firms towards OFDI. In many cases, the ownership pattern of Indian OFDI projects was minority-owned. The joint venture nature of Indian OFDI with intermediate technologies had been found to be appropriate to the needs and requirement of fellow developing countries. The Indian OFDI policy in the pre-liberalised era was more restrictive with cumbersome approval procedures.

However, the character of OFDI has undergone significant changes since nineties. A large number of Indian firms from increasing number of industries and services sectors have taken the route of overseas investment to expand globally. Unlike the earlier periods, Indian outward investors have gone for complete control over their overseas ventures and increasingly started investing in developed parts of the world economy. This increased quantum of OFDI from India has been led by a number of factors and policy liberalisation covering OFDI has been one among them. The sharp rise in OFDI since 1991 has been accompanied by a shift in the geographical and sectoral focus. Indian companies have also diversified sectorally to focus on areas of

the country's emerging comparative advantages such as in pharmaceuticals and IT software automobiles, auto-ancillary and telecom etc. Indian enterprises have also started to acquire companies abroad to obtain access to marketing.

It is contended that the new wave of OFDI reflects changes in the structure of the world economy that are a result of globalisation and regionalisation of economic activity. These phenomena are associated with:

- Technological advances within the sectors
- Liberalisation of markets
- Establishment of regional trading blocks

It is also contended that the second stage of OFDI is complementary to the first stage and simply is an intermediate stage of evolution of OFDI as the home country moves along its IDP. Such OFDI has been a result of government assisted upgrading of location specific advantages of home country, which in turn has helped upgrade the competitive advantages of their firms. Also while these ownership specific advantages remain primarily country-of-origin specific they are being supplemented by FDI intended to augment rather than exploit such advantages.

In light of the foregoing analysis, regarding the outward direct investment from developing countries especially India, it can be said that there has been a distinct and comprehensive change. The evidence presented in this study shows that the evolution of Indian OFDI is entirely consistent with the predictions of the "IDP". Each stage has been appropriate to the extent and pattern of the country's economic development.

Such a growth has been conditional on the sustained improvement of the ownership specific advantages of the firms, resulting from a continuous up gradation of the locational specific advantages of the home country. While improved Locational advantages are a natural consequence of economic development and restructuring as the country moves from stage 2 to stage 3, this process can be accelerated by a market oriented and a holistic government policy towards trade, industrial development and innovation. This has not only helped to upgrade its indigenous resources but has encouraged the domestic firms to augment their competitive advantages by acquiring foreign resources.

The findings of the empirical study are consistent with the trends and patterns of OFDI emerging from the country.

As postulated, exports positively influence outward FDI, as they ensure markets and encourage vertical FDI. This result confirms the assumption that exports are important in determining OFDI from India and that the economy's ability of improving the FDI outflows will be related to the country's performance in its trade front. The rising volumes of exports from the Indian sub region reflect the increasing competitiveness of the economy. However, it can be said that exports have been complemented by outward FDI, since the rising number of free trade agreements has made possible access to larger markets and large-scale production. Higher level of export activities by the Indian firms also implies that the need to undertake trade supporting OFDI to support their exports is also very high. Hence this calls for active OFDI promotion as it would complement export promotion resulting in greater integration with the world markets. The vertical OFDI in the form of building trade-supporting infrastructure abroad, like distribution networks, customer care centers, service centers etc., by the Indian firms to strengthen the locational advantages could help to increase the exports of the final products from the home economy. In the

case of the Indian software sector for example, on-shore presence through OFDI is critical to ensure exports of software services.

The results also corroborate the fact that the Indian companies, mainly motivated by cost considerations, undertake vertical FDI to disaggregate the production process geographically and locate specific stages of the value chain in the home country benefiting from the relative cost advantages.

However, trade in itself may not be able to boost outward FDI if the domestic investors lack the capability to invest abroad. Inward FDI flows have of late been identified as one of the drivers of outward FDI, which improve the capabilities of the domestic investors to undertake outward FDI. Better technology, better skills and information regarding the home economies of inward FDI are all necessary ingredients for enhancing domestic competitiveness.

The success of India in attracting FDI flows has had a dual impact on the domestic firms. On one hand, it has induced growing competition at home and encouraged Indian firms to go abroad, adopting a diversification strategy in generating revenues. On the other hand, exposure to international business has played a part in encouraging Indian firms to venture abroad through demonstration and spillover effects on domestic firms. Once they venture out, the Indian MNCs begin to acquire advantages related to "transnationality-confidence" and knowledge of operating in a foreign environment. More generally, the greater integration of India in the world economy and the intensification of international competition through imports and inward FDI to which Indian firms are confronted, the more MNCs will expand outside India, to acquire a portfolio of locational assets that helps them to improve their international competitiveness.

Domestic factors can be important push factors for outward FDI. Studies in the literature have found that the market size of the home economies is the most important variable which propels FDI. India has seen a sustained increase in the national income since liberalisation. Increased market size along with a buoyant manufacturing and the services sector has allowed the domestic firms to gain a competitive edge by acquiring suitable ownership advantages. As a result, domestic firms are encouraged to invest overseas.

One reason why the Indian companies are investing more in the developed countries can be because of the growing Ownership advantages of the manufacturing and the services sector, which enables them to efficiently cater the demand in those countries. The strengthening of the Ownership advantages is linked to the various linkages derived from the growth of the domestic market and competition. For example, many Indian firms in the pharmaceutical sector now have focused on product and process development, which strengthens their Ownership advantage to compete efficiently in the world market. Indeed, developed countries have been the main source of opportunities for service firms in software sector to grow and integrate with the global economy. Since much of the software activities require proximity with their developed country customers, OFDI has been used by Indian software firms to establish their fully controlled branches or subsidiaries abroad and to acquire overseas competitors for gaining market access and additional intangible assets. It is also interesting to note that the Indian companies have been able to offer a range of relatively low cost but high quality products to the consumers in the host countries. For example, Indian pharmaceutical companies have been able to provide cheap generic drugs to the people in the developed nations.

Apart from the traditional motivation of market access, OFDI has been increasingly resorted to develop trade-supporting networks abroad. A large number of customer

care and service centers have been created to ensure strong locational advantages and also to improve exports from the Indian economy. Thus the technologically advanced Indian firms have been able to exploit Ownership advantages in efficient manner by utilising the superior locational advantages offered by host countries. Indian firms also had a strong motivation to use OFDI in the brownfield form to acquire additional technologies, skills, management expertise, marketing distribution networks overseas.

Since the early nineties the Indian firms have grown globally through OFDI for a variety of reasons. The past industrialisation and developmental process had improved India's locational advantages like skills (general, technical and managerial), physical and scientific infrastructures and institutions. The firm-specific technological efforts were strongly complemented by these growing Locational advantages and India's much pursued policy of achieving technological self-reliance. A large number of Indian firms across a wide range of industries have emerged with higher levels of competitive advantages based on productivity, technology, skills, management expertise, quality and scale of production. The process of increasing globalisation including internal liberalisation, resulting in higher FDI flows, had offered capable Indian firms business opportunities at a global scale and OFDI became the efficient strategy for expanding operation overseas.

The liberalisation of government policy with respect to OFDI like granting automatic approval to the OFDI applications, removal of ceiling on the amount of outward investment, allowing Indian companies to raise financial resources for overseas acquisitions and relaxation of other restrictive rules has provided ultimate impetus to the overseas expansion activities of Indian enterprises.

The emergence of knowledge-based segment of Indian economy such as drugs and pharmaceuticals, software and broadcasting as the leading outward investors indicate the rapid pace at which India is enhancing global position in knowledge based economy. During the second wave the technological capabilities of Indian enterprises have seen diversification towards basic and frontier research activities under the facilitating role of national innovation system. For example, many of the leading Indian pharmaceutical firms like Ranbaxy, Dr Reddy's Labs among others have made significant progress in directing their R&D focus on new product developments. May be modestly, the ownership advantages of Indian OFDI in industries such as pharmaceutical, software and transport now seem to be based on advanced technologies.

While rapid rise of OFDI is a natural process in an open economy, it faces many uncertainties and risks in sustaining their global sales and revenues. With increasing globalisation, Indian companies will have to continuously adapt themselves to successfully counter increasing competition. To manage technology as a global firm, Indian firms need to take up technology, when it is in the growth stage, develop design capabilities, bring out product innovations and differentiate their products / services with technology. The large R&D expenditure of companies can translate into substantial competitive strength for them. Indian companies suffer the disadvantage of inadequate expenditure on R&D to develop process know-how and engineering skills.

Another issue that hampers trade is the lack of protection for Intellectual Property Rights. Generally, countries and companies trading with India feel that intellectual property protection is weak in India. However, there is a rise in the number of patent applications, given the general increase in economic activity in the same period.

Not many Indian consulting firms have ISO accreditation that can enhance the quality image of Indian firms in the eyes of overseas investors. Project export companies have made good progress in areas like civil construction, turnkey projects, technical services, and earned a niche for themselves. The projects range from power generation, transmission and distribution, dams, tunnels, oil exploration, operation and maintenance to export of capital goods, transport equipment and consultancy services. But presently the Indian companies have been facing competition primarily from, exporters from developed countries and newly industrialising countries. Simultaneously at the macro level, the boom in the outward investments is likely to increase external pressure on India to quickly reduce tariffs and dismantle the remaining restrictions on capital inflows. Calibrating these moves without forgoing the interests of the vast unincorporated sector enterprises and the rural economy would remain a challenge for policy-maker.

### **Limitations**

Due to the inherent data constraints of the macro economic time series data, the above results are admittedly tentative. Yet it is true that they reveal certain new facets of the FDI outflows from India that have not been examined earlier. Moreover, India's success in outward FDI is very recent, dating back to the economic reforms of the nineties. With such a short history, it is yet to be seen whether the time series data can sustainably display the relations that the empirical evidence of this study suggests or whether the interaction of the home country and host country economic forces change the prevailing relationship pattern.



## **Scope of Further Research**

A natural extension of this study would be to examine the effects of international trade and variables on the FDI outflows of the competing Asian countries like China and South Korea and compare the outcomes with those of India. There is a possibility that the drivers of OFDI differ in significance with respect to different sectors. A detailed and separate analysis is therefore required for explaining OFDI from the manufacturing and the services sector. Another interesting research avenue would be to examine the impact of OFDI on the exports and employment of the Indian economy. A study on harmonising inward and outward policies so as to enhance mutual growth inducing effects in the home and host country would also be very much in place.

## **SECTION 7.3**

### **CONTRIBUTION OF THE STUDY**

Since outward FDI from India is a recent phenomenon, studies in this area have been few and far between. In this study an attempt has been made to examine the applicability of John Dunning's "Investment Development Path" to understand the evolution of outward FDI flows from India. The analysis shows that India surely has evolved to "Stage 2" of the "IDP" on the parameters proposed by Dunning.

Furthermore, both inward and outward FDI flows have been studied in the light of the "Eclectic Paradigm" put forward by John Dunning. The findings shed light on factors which are consistent with the new developments in the area of international trade and have not been comprehensively studied in the earlier studies. The outcomes also link inward and outward FDI together in a way that gives meaningful insights to make the second generation reforms more successful.

Facts and empirical results evidenced in this study show that the motives for both inward and outward FDI are changing. "Efficiency seeking" investment is gaining more importance as compared to "market seeking" both for domestic as well as foreign investors. Productivity in the economy has emerged as a very important factor which is attracts more vertical FDI as compared to horizontal FDI. Growing competition and economic spillovers from increased FDI inflows along with cost advantage due to productivity gains have induced more FDI abroad which is also increasingly vertical in nature. Thus inward FDI has emerged as an all contributing and important factor influencing outward FDI flows from India. This implies that the growth of IFDI and OFDI is complementary and policies need to be framed in a way

that the linkages between them are strengthened and beneficial to the overall economy.