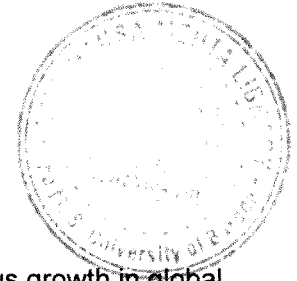


CHAPTER 1

INTRODUCTION



INTRODUCTION

During last twenty to twenty-five years, there has been a tremendous growth in global Foreign Direct Investment (FDI). In 1980 the total stock of FDI equaled only 6.6 percent of world Gross Domestic Product (GDP), while in 2003 the share had increased to close to 23 percent (UNCTAD 2004). This dramatic development has taken place simultaneously with a substantial growth in international trade. The growth in international flows of goods and capital implies that geographically distant parts of the global economy are becoming increasingly interconnected as economic activity is extended across boundaries. FDI is an important factor in the globalisation process as it intensifies the interaction between states, regions and firms. Growing international flows of portfolio and direct investment, international trade, information and migration are all parts of this process. The large increase in the volume of FDI during the past two decades provides a strong incentive for research on this phenomenon.

This dissertation investigates different aspects of FDI at the macro economic level using aggregated data for FDI. The choice of research topics has been made in order to allow for the possibility of finding results that can provide knowledge about the nature of FDI that may help policy makers of both home and host¹ country to take appropriate decisions.

¹ Henceforth, 'host country' refers to a country that receives an inflow of FDI while 'home country' refers to a country that generates an outflow of FDI.

SECTION 1.1

THEORETICAL EXPOSITION OF FDI

Financial flows can be put into four categories:

1. Private Debt Flows: They are comprised of bonds, bank loans and other credits issued or acquired by private sector enterprises in a country without any public guarantee.
2. Official Development Finance: It consists of Official Development Assistance (ODA) and other official flows –
 - i. Official Development Assistance: ODA consists of net disbursements of loans and grants made on concessional terms by official agencies of the members of the Development Assistance Committee (DAC) and certain Arab countries to promote economic development and welfare in recipient economies that are listed as developing by the DAC. Loans with a grant element of more than 25 percent are included in ODA. ODA also includes technical co-operation and assistance.
 - ii. Other Official Flows: These are transactions by the official sector whose main objective is other than development or whose grant element is less than 25 percent such as official export credits, official sector equity and portfolio investment and debt re-organisation undertaken by the official sector on non-concessional terms.

3. Foreign Portfolio Investment: Foreign portfolio investment involves –

- i. Purchase of existing bonds and stocks with the sole objective of obtaining dividends or capital gains.
- ii. Investment in new issues of international bonds and debentures by the financial institution or foreign government.

4. Foreign Direct Investment: Direct investment is assumed to have occurred when an investor has acquired 10 percent or more of the voting power of a firm located in a foreign economy. (IMF 2004a)²

CONCEPTS OF FDI

1. Foreign Direct Investment Entity

There are different ways in which firms and individuals can hold assets in a foreign country. The definition of a “foreign direct investment entity” decides which of these are considered as direct investment and which firms are considered as multinational enterprises.

A foreign direct investment entity has been defined differently for Balance of Payment (BOP) purposes and for the purpose of the study of firm behavior. The definition of foreign direct investment as a capital flow and a capital stock has changed correspondingly.

The dominant current definition of FDI entity prescribed for BOP compilations by the IMF (1993) and endorsed by the OECD avoids the notion of control by

² Lipsey (2003) provides a detailed description of how the definition of FDI has changed over time.

the investor. "Direct investment is the category of international investment that reflects the objective of a resident entity in one economy obtaining a lasting interest in an enterprise resident in another economy (the resident entity is the direct investor and the enterprise is the direct investment enterprise). The lasting interest implies the existence of a long term relationship between the direct investor and the enterprise and a significant degree of influence by the investor on the management of the enterprise." (IMF 1993)

A direct investment enterprise is defined in the IMF BPM5 (Balance of Payments manual 5) as an incorporated or unincorporated enterprise in which a direct investor, who is a resident in another economy, owns 10 percent or more of the ordinary shares or voting power (for an incorporated enterprise) or the equivalent (for an unincorporated enterprise) (IMF, 1993).

The IMF definition is governing for BOP compilations, but there is a different, but related, concept and a different official definition in the United Nations System of National Accounts, the rule book for compiling national income and product accounts, that retains the idea of control and reflects a more micro view. In these accounts, which measure production, consumption, and investment, rather than the details of capital flows, there is a definition of "Foreign Controlled Resident Corporation". Foreign controlled enterprises include subsidiaries more than 50 percent owned by a foreign parent. "Associates" of which foreign ownership of equity is 10-50 percent "May be included or excluded by individual countries according to their qualitative assessment of foreign control" (Inter-Secretariat Working Group on National Accounts, 1993, pp. 340-341). Thus from the view point of the host country and for analyzing production, trade, and employment, control remains the preferred concept.

2. FDI Flows

The definition of FDI flows has changed over time as the definition of FDI enterprises has changed. Direct investment capital flows are made up of "...equity capital, reinvested earnings, and other capital associated with various inter-company debt transactions." (IMF, 1993) The last category is the most difficult, covering "...the borrowing and lending of funds including debt securities and supplier's credits between direct investors and subsidiaries, branches and associates." This includes "...inter-company transactions between affiliated banks (depository institutions) and affiliated financial intermediaries...." However, the later are now to be included in direct investment only if they are "...associated with permanent debt (loan capital representing a permanent interest) and equity (share capital) investment or, in the case of branches, fixed assets". Deposits and other claims and liabilities related to usual banking transactions of depository institutions and claims and liabilities of other financial intermediaries are classified under portfolio investment or other investment. (IMF, 1993)

DEFINITION OF FDI

There is no specific definition of FDI owing to the presence of many authorities like the OECD, IMF, IBRD, and UNCTAD. All these bodies attempt to illustrate the nature of FDI with certain measuring methodologies. Generally speaking FDI refers to capital flows from abroad that invest in the production capacity of the economy and are usually preferred over other forms of external finance because they are non-debt creating, non-volatile and their returns depend on the performance of the projects

financed by the investors. FDI also facilitates international trade and transfer of knowledge, skills and technology. It is also described as a source of economic development, modernisation and employment generation, whereby the overall benefits triggers technology spillovers, assists human capital formation, contributes to international trade integration and particularly exports, helps to create a more competitive business environment, enhances enterprise development, increases total factor productivity and improves efficiency of resource use.

IMF–OECD DEFINITION

FDI statistics are a part of the BOP statistics collected and presented according to the guidelines stated in the IMF BPM5 Manual, fifth edition (1993) and OECD Benchmark definition of FDI (2003).

The IMF definition of FDI is adopted by most of the countries and also by UNCTAD for presenting FDI data.

According to IMF BPM5, paragraph 359, FDI is the category of international investment that reflects the objective of a resident entity in one economy (direct investor or parent enterprise) obtaining a 'lasting interest' and control in an enterprise resident in another economy (direct investment enterprise).

The two criteria incorporated in the notion of 'lasting interest' are:

- i. The existence of a long term relationship between the direct investor and the enterprise.

- ii. The significant degree of influence that gives the direct investor an effective voice in the management of the enterprise.

The concept of lasting interest is not defined by IMF in terms of a specific time frame, and the more pertinent criterion adopted is that of the degree of ownership in an enterprise. The IMF threshold is 10 percent ownership of the ordinary shares or voting power or the equivalent for unincorporated enterprises. If the criteria are met, then the concept of FDI includes the following organisational bodies:

- i. Subsidiaries: (in which the non resident investor owns more than 50 percent)
- ii. Associates: (in which the non resident investor owns between 10-50 percent)
- iii. Branches: (unincorporated enterprises, jointly or wholly owned by the non-resident investor)

COMPONENTS OF FDI

The BPM5 and the benchmark recommend that FDI statistics can be compiled as a part of the BOP and international investment position statistics. Consequently countries are expected to collect and disseminate FDI data according to the standard components presented in the BPM5. The concept of FDI includes the capital funds that the direct investor provides to a direct investment enterprise as well as the capital funds received by the direct investment enterprises from the direct investor. It comprises not only the initial transaction establishing the relationship between the investor and the enterprise but also all subsequent transactions between them and among affiliated enterprises, both incorporated and unincorporated (IMF, 1993).

The components of Direct Investment constitute direct investment income, direct investment transactions and direct investment position. FDI flows are the sum of three basic components; viz. equity capital, reinvested earnings and other capital associated with inter-company debt transactions:

- i. **Equity Capital:** It consists of the value of the MNCs investment in shares of an enterprise in a foreign country. It consists of non cash which can be in the form of tangible and intangible components such as technology fee, brand name etc. It comprises equity in branches, all shares in subsidiaries and associates and other capital contributions.
- ii. **Reinvested Earnings:** It consists of the sum of the direct investor's share (in proportion to the direct equity participation) of earnings not distributed as dividends by subsidiaries or associates and earnings of branches not remitted to the direct investor.
- iii. **Other Direct Investment Capital:** They are also known as inter-company debt transactions. They cover the short and long term borrowing and lending of funds including debt securities and supplier's credit-between direct investors and subsidiaries, branches and associates (BPM5). In sum direct investment capital transactions include those operations that create or liquidate investments as well as those that serve to maintain, expand or reduce investments.

The IMF definition thus includes as many as twelve different elements, namely: equity capital, reinvested earnings of foreign companies, inter-company debt transactions including short term and long term loans, overseas commercial borrowing (financial leasing, trade credits, grants, bonds), non cash acquisition of equity, investment made by foreign venture capital investors, earnings data of indirectly held FDI enterprises, control premium, non competition fee and so on.

FDI defined in accordance with IMF guidelines can take the form of Greenfield investment in a new establishment or merger and acquisition of an existing local enterprise known as Brownfield investment.

FDI ACCOUNTING IN INDIA

FDI statistics in India are monitored and published by two official sources: Reserve Bank of India (RBI) and Secretariat of Industrial Assistance (SIA) in the Ministry of Commerce and Industry.

REVISED FDI DEFINITION

In the Indian context till the end of March 1991, FDI was defined to include investment in:

- i. Indian companies which were subsidiaries of foreign companies
- ii. Indian companies in which 40 percent or more of the equity capital was held outside India in one country
- iii. Indian companies in which 25 percent or more of the equity capital was held by a single investor abroad.

As a part of its efforts to bring about uniformity in the reporting of international transactions by various member countries, the IMF has provided certain guidelines which enable inter-country comparisons. Reflecting this with effect from March 31, 1992 the objective criterion for identifying direct investment has been modified and is fixed at 10 percent ownership of ordinary share capital or voting rights. Direct

investment also includes preference shares, debentures and deposits, if any, of those individual investors who hold 10 percent or more of equity capital. In addition to this, direct investment also includes net foreign liabilities of the branches of the foreign companies operating in India.

A committee was constituted by the Department of Industrial Policy and Promotion (DIPP) in May 2002 to bring the reporting system of FDI data in India into alignment with international best practices. Accordingly, the RBI has recently revised data on FDI flows from the year 2001 onwards by adopting a new definition of FDI. The revised definition includes three categories of capital flows under FDI; equity capital, reinvested earnings and other direct capital. Previously the data on FDI reported in the BOP statistics used only equity capital.

TYPES OF FDI

- i. Inward Foreign Direct Investment: This refers to long term capital inflows into a country other than aid, portfolio investment or a repayable debt. It is done by an entity outside the host country in the home country.
- ii. Outward Foreign Direct Investment: This refers to a long term capital outflow from a country other than aid, portfolio investment or a repayable debt. It is done by an entity outside the host country in the home country.
- iii. Horizontal Foreign Direct Investment: This refers to a multi-plant firm producing the same line of goods from plants located in different countries
- iv. Vertical Foreign Direct Investment: If the production process is divided into upstream (parts and components) and downstream (assembly) stages, and only the latter stage is transferred abroad, then the newly established assembly plant's demand for parts and components can be met by exports

from home-country suppliers. This is what Lipsey and Weiss (1981, 1984) and other researchers describe as “Vertical FDI”, whose aim is to exploit scale economies at different stages of production arising from vertically integrated production relationships.

- v. Greenfield Foreign Direct Investment: Greenfield FDI is a form of investment where the MNC constructs new facilities in the host country.
- vi. Brownfield Foreign Direct Investment: Brownfield FDI implies that the MNC or an affiliate of the MNC merges with or acquires an already existing firm in the host country resulting in a new MNC affiliate.

MULTINATIONAL CORPORATIONS

Multinational Corporations (MNC) or Transnational Corporations (TNCs) are the most important carriers of FDI. According to the World Investment Directory, MNCs are incorporated or unincorporated enterprises comprising parent enterprises and their foreign affiliates. A parent enterprise is defined as an enterprise that controls assets of other entities in countries other than its home country, usually by owning a certain equity capital stake.

An equity capital stake of 10 percent or more of the ordinary shares or voting power for an incorporated enterprise or its equivalent for an unincorporated enterprise is normally considered as a threshold for the control of assets.

A foreign affiliate is an incorporated or unincorporated enterprise in which an investor who is a resident in another economy owns a stake that permits a lasting interest in the management of that enterprise.

An MNC can be defined as an entity which has one or more of the following criterion:

- i. Sole proprietorship held abroad
- ii. Foreign branches of the company
- iii. Subsidiaries of the company
- iv. Associates

TYPES OF MNCs

- i. National Firms: This refers to single plant firms with headquarters and plant in the same country.
- ii. Horizontal Multinationals: This refers to two plant multinationals which engage in producing the same line of goods across plants in different countries.
- iii. Vertical Multinationals: This refers to two plant multinationals which engage in dividing the production process in parts and components across different plants across the nations to take advantage of the scale economies arising from vertically integrated production relationships.

COMPILATION OF FDI DATA

Generally, there are two main alternatives for compiling FDI data:

- i. To use Balance Of Payments statistics or
- ii. To perform firm surveys

The Balance of Payments data measures FDI as the financial stake of a 'parent' in a foreign affiliate. The advantage of Balance of Payments data is that they can be

collected relatively easy for virtually all existing countries. Unlike Balance of Payments data, firm surveys focus on the actual operations of MNCs.

FDI data is reported as a stock or a flow value. As described in IMF (2004a), flows of FDI consist of equity capital, reinvested earnings and what is usually referred to as 'other capital'. Data on FDI flows are on a net basis i.e. (capital transactions' credits less debits between direct investors and their foreign affiliates). Net decreases in assets (outward FDI) or net increases in liabilities (inward FDI) are recorded as credits (recorded with a positive sign in the balance of payments), while net increases in assets or net decreases in liabilities are recorded as debits (recorded with a negative sign in the balance of payments). The negative signs are reversed for practical purposes in the case of FDI *outflows*. Hence, FDI flows with a negative sign indicate that at least one of the three components of FDI (equity capital, reinvested earnings or intra-company loans) is negative and is not offset by positive amounts of the other components. These are instances of reverse investment or disinvestment. Stocks of FDI are similarly composed of equity capital, reinvested earnings and other capital. However, data on FDI stocks is presented at book value or historical cost, reflecting prices at the time when the investment was made

Inflows of FDI and the inward stock of FDI is a result of investment performed in the host country by foreign MNCs. Correspondingly, outflows of FDI and the outward stock of FDI represents investment in foreign countries performed by MNCs based in the source country.

FDI data is collected and reported by several international organisations:

- i. IMF compiles and reports FDI data for the majority of the countries in the world. The data is based on balance of payments statistics and according to

IMF (2004a) compiled from international transactions reporting systems and data from exchange control or investment control authorities.

- ii. UNCTAD prepares the annual publication of the World Investment Report. The report presents data for both flows and stocks of FDI as well as additional data such as the share of FDI in GDP. The report presents data for most countries. UNCTAD primarily tries to collect data directly from national official sources such as the central banks and statistical offices of individual economies. If this is not possible, data is complemented or obtained from the IMF or the OECD.
- iii. OECD reports FDI data for its member countries. The data is primarily based on Balance of Payments statistics as reported from the central banks and is presented in the International Direct Investment Statistics Yearbook. Data for bilateral flows of FDI is reported and there is some data for the distribution of FDI among industrial sectors in the OECD economies.
- iv. The World Bank includes FDI data among the so-called World Development Indicators. The data is primarily based on Balance of Payments data from the IMF and cover most countries.
- v. There are also a number of regional organisations such as ASEAN and EBRD reporting data for particular geographical regions. The EBRD presents FDI data for the European transition economies in the annual publication Transition Report (e.g. EBRD 2004). The FDI data is compiled on the basis of data from the IMF, data from central banks and EBRD's own estimates and survey.

LIKELY BENEFITS OF FDI

- i. FDI is less volatile than other private flows and provides a stable source of financing to meet capital needs.

- ii. FDI is an important and probably dominant channel of international transfer of technology. MNCs, the main drivers of FDI are powerful and effective vehicles for disseminating technology from developed to developing countries and are often the only source of new and innovative technology which is not available in the arm's length market.
- iii. The technology disseminated through FDI generally comes as a package including the capital, skills and managerial knowhow needed to appropriate technology properly.

LIKELY COSTS OF FDI

Recent years have seen increased public concern that the benefits of FDI have yet to be demonstrated and that, where benefits exist, they may not be shared equitably in the society. The adjustment costs associated with FDI include:

- i. Higher short term unemployment due to corporate restructuring
- ii. Increased market concentration
- iii. Incomplete utilisation of FDI benefits due to incoherent institutional policies and regulatory conditions, unavailability of skilled labor and infrastructure.

The debate on the likely costs and benefits has reached new heights. Under these circumstances it is important to inform the discussion by drawing lessons from the country experience and to assist the Government in identifying the conditions and policy requirements for maximising the benefits of FDI and minimising the risks and potential costs.

SECTION 1.2

RELEVANCE OF THE PRESENT STUDY

It is widely known that capital flows into developing economies like India have risen sharply in nineties and has, therefore, become a self propelling and dynamic actor in the accelerated growth of the economies. This study focuses on FDI as a vector of Indian globalisation. Recently not only did India become a more frequent destination for FDI, but also many Indian firms have started investing abroad in a big way. Thus we find a surge in both inward and outward FDI flows. The impassioned advocacy of increased FDI flows (inward and outward) is based on the well worn arguments that FDI is a rich source of technology and knowhow; it can invigorate the labour oriented export industries of India, promote technological change in the industries and put India on a higher growth path. This exuberance of FDI needs to be based on analytical review of India's needs and requirements and her potential to participate in huge investment flows. Thus there is a definite need to incorporate the various dimensions of FDI into a theory of open economy development so as to explain in one integrated theoretical paradigm, the undercurrents of both inward and outward FDI flows.

The empirical literature on the relationship between FDI and development is mixed. Despite a number of studies and seeming contradictions, two consistent issues that repeatedly arise are:

- i. What are the motivations / reasons for FDI flows?
- ii. What are the economic implications of FDI flows?

Hence a detailed analysis of FDI into India requires an examination of the determinants and impact of FDI in the Indian economy. Studying both inward and outward FDI flows together will help to assess the nature and the true extent to which the Indian economy has globalised.

This study takes a closer look at the structure of Foreign Direct Investments into and from India. It traces the development of India's economic policy regarding FDI and the resulting changes in both inflows and outflows. The expansion of FDI into and from India has been accompanied by a rapid economic growth and an increasing openness to the rest of the world. It is equally important to understand why India has become one of the important beneficiaries of FDI in the world and what drives the more recent progress of India's outward FDI.

SECTION 1.3

OBJECTIVES OF THE STUDY

In order to appreciate the importance of FDI flows for the Indian economy, it would be pertinent to examine the changes in the global FDI flows and the place of India within. In this respect the following issues shall be studied with respect to inward flows to and outward flows from India:

- The nature and extent of Indian economy's integration with the world economy
- The nature of the regional distribution of FDI flows from the global FDI flows
- The comparative standing of FDI among developing countries
- The pattern of originating and destination countries of Indian FDI flows
- The nature of change in the sectoral composition of FDI in India
- The regional distribution of inward FDI in India
- The structure of cross border mergers and acquisitions from India
- The FDI flows as a percentage of GDP and GFCF
- FDI performance v/s potential in India
- Major policy initiatives taken to boost FDI flows

Why do firms go abroad? Why do they choose to invest in a specific location? These are some of the questions that have plagued scholars since the advent of interest in FDI. The origins of the theoretical literature on the determinants of FDI are to be found in Stephen Hymer's (1960) doctoral dissertation. His thesis, briefly put, is that firms go abroad to exploit the rents inherent in the monopoly over advantages they possess and FDI is their mode of operations. The advantages firms possess include

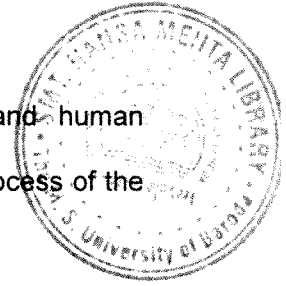
patented technology, team specific managerial skills, marketing skills, and brand names. All other methods of exploiting these advantages in external markets, such as licensing agreements and exports are inferior to FDI because the market for knowledge or advantages possessed by firms tends to be imperfect. In other words they do not permit firms to exercise control over operations essential for retaining and fully exploiting the advantages they own. Hymer's insights form the basis of other explanations such as transactions costs and internationalisation theories, most of which in essence , argue that firms internalise operations, forge backward and forward linkages in order to bypass the market with all its operations.

John Dunning (1977, 1981) neatly synthesises these and other explanations in his well known "eclectic paradigm" or the "OLI" explanation of FDI. For a firm to successfully invest abroad, it must possess advantages which no other firm possess (Ownership), the country it wishes to invest should offer locational advantages (Location), and it must be capable of internalising operations (Internalisation) i.e. the "OLI" theory. Internalisation is synonymous with the ability of the firms to exercise control over such operations. And such control is essential for the exploitation of the advantages which the firm possesses and the location advantage which the host country offers. It is the location advantages emphasised by Dunning which forms much of the discussion on the determinants of FDI in developing countries. The two other attributes necessary for FDI are taken as given from the perspective of the developing countries. Dunning set the ball rolling on econometric studies with a statistical analysis of survey evidence on the determinants of FDI. His study identified three main determinants of FDI in a particular location: market forces (including market size and growth as determined by the national income of the recipient country), cost factors (such as labour cost and availability and the domestic inflation situation) and the investment climate (as determined by such considerations as the extent of foreign indebtedness and the state of BOP).

Foreign investors are attracted to economically dynamic countries. They look for factors like high and growing per capita incomes, large domestic markets, well educated work force, well developed physical and technological infrastructure, proximity to export markets, social and political stability and the presence of other foreign investors called as “agglomeration effect”. What is crucial in attracting FDI is the country’s “absorptive capacity” or those factors that promote domestic economic growth through investment, infrastructure and human capital development. Accordingly it can be said that, growth and development leads to FDI rather than FDI leading to growth and development. Labour costs might be a more significant determinant of inward FDI in developing countries when these inflows reflect an intention to minimise production costs. This type of FDI is commonly referred as “efficiency seeking” and “market seeking” FDI. “Resource seeking” investors come into countries in order to exploit natural resources and factors like physical infrastructure and the pool of labour jointly determine the profitability of such investments. “Market seeking” investors make investments in order to sell their products in the host country’s domestic markets so they are more concerned with factors like domestic market size and per capita income.

Although the empirical literature continues to grow unabated, its overall message can be summarised in the following propositions, some of which shall be put to an examination in this study:

- i. Host countries with a sizeable domestic market, measured by GDP per capita and sustained growth of these markets measured by growth rates of GDP, attract relatively large volumes of FDI.



- ii. Resource endowments of a host country including natural and human resources are a factor of importance in the investment decision process of the foreign firms.
- iii. Infrastructure facilities including transportation and communication are important determinants of FDI. An unexplored issue has been the role of information decisions. FDI requires substantial fixed costs of identifying an efficient location, acquiring knowledge of the local regulatory environment and coordination for supplies. Thus access to better information may make FDI to that location more likely.
- iv. Macro economic stability signified by stable exchange rates and low rates of inflation is a significant factor in attracting foreign investors.
- v. Political stability in the host countries is an important factor in the investment decision process of foreign firms.
- vi. A stable and transparent policy framework towards FDI is an attractive factor to potential investors.
- vii. Foreign firms place a premium on a distortion free economic and business environment. An allied proposition here is that a distortion free foreign trade regime which is neutral in terms of the incentives it provides for Import Substitution (IS) and Export Promoting (EP) industries attracts relatively large volumes of FDI than either an IS or EP regime.
- viii. Fiscal and monetary incentives in the form of tax concessions do play a role in attracting FDI. MNCs are potentially subject to taxation in both the host and home countries. It is found that the way in which parent country reduces double taxation on their MNCs can have implications for FDI.
- ix. Trade protection is also found to encourage FDI. It is found that FDI response to these trade actions (tariff jumping FDI) occurs only for firms with previous experience as MNCs.

- x. Wages are an important factor determining inward FDI. It is possible that lower wages are associated with higher levels of inward FDI. However, where there is a control for productivity, there could be a positive association found between FDI and the types of labour standards that may raise wages but that ultimately contributes to worker's productivity. It is found that FDI is positively correlated to the right to establish unions, to strike, to collective bargaining and to the protection of the union members.

The aim of this study is to investigate the determinants of FDI in India from the perspective of country characteristics, identifying the most significant factors in India that influence foreign investors' decision to invest in the country. Several location advantages as determinants of FDI in India, drawn from previous studies, will be tested.

Traditionally rich developed economies started FDI into other developed / developing economies to maximise the economic rent earned on capital. The developing and underdeveloped economies were viciously gripped by low levels of productivity leading to a low wage level and hence low level of savings and investment. Low levels of investment again perpetuate low levels of productivity. This inward spiral needs an external stimulus in the form of FDI. This could raise efficiency and expand output leading to economic growth in the country. The inward spiral then could turn outward signaling growth and prosperity. The direction of FDI by countries – Inward Direct Investment (IDI) and Outward Direct Investment (ODI) was developed by John Dunning in a theory named "Investment Development Path" or "IDP". He said that outward and inward direct investment position of a country is systematically related to its economic development relative to the rest of the world. The "IDP" suggests that countries tend to go through five main stages of development and these stages can

be classified according to the propensity of those countries to be outward or inward direct investors. In sequence these stages are:

- i. Non-existence of both inward and outward FDI
- ii. Emergence and expansion of inward FDI and bare existence of outward FDI
- iii. Expansion of outward FDI and slowing growth of inward FDI
- iv. Outward FDI stock exceeding inward FDI stock
- v. Net outward FDI stock (Gross outward FDI stock – Gross of FDI stock) fluctuating to zero level

This suggests that a country's outward FDI will not be large until the inward FDI increases. As indicated by the 'IDP' path, India has already started its move as an outward investor and is in the second stage of the IDP.

Initiating from nineties, India's successful industrialisation contributed to the growth of its FDI abroad. This increase in outward FDI (OFDI) suggests that the country is moving rapidly towards becoming a developed and mature economy.

As regards the outward foreign direct investment from India, the hypothesis examined is as follows:

"Outward FDI from India has undergone a fundamental shift, which can be successfully explained as stage two, within the framework of the Investment Development Path"

There are several factors that explain the emergence of India as a heavy OFDI investor. First the surge of OFDI has coincided with that of all FDI. Since the mid 1980s, worldwide flows of FDI have grown at unprecedented rates. Indian MNCs

were influenced by this trend and began to participate actively by organising their own corporate network around the world. Rapid economic growth in the Asia-Pacific region has been the second factor contributing to Indian international investment. Many countries in the Asia-Pacific region adopted policies towards international trade and investment which helped to accelerate domestic economic growth. Third, India's emergence as an outward investor was the direct result of the country's rapid industrialisation strategy and outward looking policies. Finally shifts in India's comparative advantage have played an important role in increasing the country's foreign presence.

Following are the push factors explaining OFDI, some of which shall be put to examination in this study:

- i. **Economic Growth:** The most important factors that may affect the FDI flows, as recognised in the literature, are the domestic market-related variables. Both current market size and potential market size can have a significant influence on outward FDI. Small market size and potential risk of losing market share may act as push factors for outward FDI. One of the main factors contributing to the outward FDI can be linked to the income of a country. Increase in the income of a country eventually will lead to structural changes to the economy of the country. The mounting of income enables firms to gain competitive advantage by enlarging the production scale as well as adoption of new technology. Ultimately, firms are able to acquire ownership advantages which become the driving force for establishing foreign production
- ii. **Exports:** Increased exports may assure the producers of existing markets and therefore lower the uncertainties and risks attached to investments, thereby encouraging outward FDI. This effect is stronger if exports are targeted towards a region with trade and investment agreements, which ensures access

- to larger integrated markets and the possibility of cross-border vertical integration and smooth operations of affiliates. Such outward FDI are undertaken mainly with the motive of expansion.
- iii. Imports: Increased imports into the country may have a displacement effect on investments, which may then be channeled outward into economies with lower manufacturing costs and greater access to larger markets. Such investments are undertaken mainly with the motive of relocation.
 - iv. Inflow of FDI: Inward FDI flows may be a potential factor that may influence the capability of domestic investors to undertake outward FDI. FDI is expected to improve the technological standards, efficiency and competitiveness of domestic industry. FDI is also associated with bringing in "relatively" more up-to-date technology into the industry since markets for technology are imperfect. The higher the inflow of FDI, the higher will be the capability of domestic investors to undertake investments abroad. Though existing FDI stock as a determinant of inward FDI flows has been used in many studies, none of the studies have as yet estimated the impact of inward FDI on outward FDI.
 - v. Infrastructural Availability: It is expected that the lower the availability of infrastructure, higher will be the infrastructure costs and higher will be the outward FDI.
 - vi. Cost Factors: Other domestic drivers of outward FDI are those that cause investment cost differentials across countries. These include costs of labour, capital and infrastructure. Cost factors may significantly influence the choice of an investment location for the "resource-seeking" and "efficiency-seeking" FDI. It is expected that higher real wages and efficiency wages in the home country increases outward FDI.
 - vii. Regional Trade Agreements: With regard to the regional trade agreements, it is found that an increasing number of trade agreements of the home country will likely shift the production units into the site with the lower costs of production

since access to home as well as host-country markets becomes available. Further, many regional trade agreements not only improve market access but also improve the investment environment to make it more conducive to a free flow of FDI.

- viii. Tax Policies: Domestic policies with respect to taxes can also influence the cost of investments across economies. The higher the tax, the higher will be outward FDI.
- ix. Domestic Labour Environment: A favourable labour environment, which is influenced by flexible labour laws, also influences the decisions to invest. The more rigid the labour laws, the higher will be the incentive to invest abroad.
- x. Exchange Rates: Exchange rate is an influential factor in affecting the outward FDI. Appreciation of the currencies enables firms from those countries to gain benefits in financial terms to support their abroad investment relative to countries with weaker currencies.

The literature on outward FDI from the developing economies is limited. Although studies have examined the trends in outward FDI from the developing countries and analyzed the drivers, few studies have empirically estimated the impact of these drivers on outward FDI, especially from the developing countries.

The purpose of this study is to empirically investigate the dynamic relationship between changes in macro economic factors and changes in FDI made by the Indian firms. The impact of inward FDI coming to India on the outward FDI from India is also examined. The study focuses on the period from 1980-2005. 1980 is chosen as the starting point as OFDI began in a small way from that period onwards.

SECTION 1.4

METHODOLOGY AND SOURCES OF DATA

The data used in this study is aggregate annual time series at current prices, covering the period 1980-2005. A process of gradual relaxation of controls and regulations with a view to attract large inflows of foreign investments was discernable from the year 1981. In a limited and phased manner market forces were allowed to govern the foreign investment flows during this period. Hence this period was selected. The inward and outward FDI data have been considered as flow measures rather than stocks because inward and outward FDI behavior is more comprehensively measured for flows than for stocks.

This study builds on existing research studies and methodologies, to test the determinants of inward and outward investment from India. Relevant studies, done so far, have been both qualitative and quantitative in nature. The qualitative methods used include surveys and questionnaires and oral interviews. However, there are a number of challenges and issues that crop up when qualitative methods are used specially in econometric studies. These include subjectivity and bias of responses and the inability to incorporate such biases in the econometric studies. As such this study uses the method of Multiple Linear Regression model. In order to estimate the regression model, a statistical software, Statistical Package for Social Sciences (SPSS), has been used.

The data was extracted from the following sources:

- i. Hand Book of Statistics on the Indian economy, RBI, various issues

- ii. UNCTAD, WIR series, various issues
- iii. Economic Survey, Government of India, various issues
- iv. World Development Indicators, World Bank

The following two hypotheses are studied using this methodology.

- i. Pull (Locational) factors determine the flow of Inward Foreign Direct Investment to India.
- ii. The Push factors determine the flow of Outward Foreign Direct Investment from India.

SECTION 1.5

THESIS OUTLINE

Chapter 1: Introduction

The areas covered in this chapter are as follows:

- Theoretical exposition of Foreign Direct Investment
- Definition and concepts of FDI
- Relevance of the present study
- Objectives of the present study
- Methodology and sources of data

Chapter 2: Review of Literature

This chapter comprises a review of the major works done in the area of Foreign Direct Investment in India and internationally.

Chapter 3: Inward Foreign Direct Investment in India: Trends And Patterns

The issues that have been studied in this chapter are:

- The nature and extent of Indian economy's integration with the world economy.
- The nature of the regional distribution of FDI flows from the global FDI flows.
- The comparative standing of FDI among developing countries.

- The pattern of originating countries of Indian FDI flows.
- The nature of change in the sectoral composition of FDI in India.
- The regional distribution of inward FDI in India.
- The structure of cross border mergers and acquisitions from India.
- The FDI flows as a percentage of GDP and GFCF.
- FDI performance v/s potential in India.
- Major policy initiatives taken to boost FDI flows.

Chapter 4: Outward Foreign Direct Investment in India: Trends And Patterns

The issues that have been studied in this chapter are:

- The comparative standing of India among developing countries
- The pattern of destination countries of Indian FDI flows
- The nature of change in the sectoral composition of FDI flows from India
- The structure of cross border mergers and acquisitions from India
- The FDI flows as a percentage of GDP and GFCF
- FDI performance v/s potential in India
- Major policy initiatives taken to boost FDI out flows

Two major questions are addressed here:

- Whether the OFDI from India has undergone a fundamental shift that might be considered as a distinct second wave of OFDI, which differs substantially from the first wave?
- Whether this new wave can be successfully explained within the framework of the "IDP" (Investment Development Path)?

As regards the outward foreign direct investment from India, the hypothesis examined is as follows:

“Outward FDI from India has undergone a fundamental shift, which can be successfully explained as stage two, within the framework of the Investment Development Path”

Chapter 5: Determinants of Inward FDI to India

The issues studied in this chapter are as follows:

- Theories of inward FDI
- Literature review and theoretical framework
- Empirical determination of the Locational determinants (Pull factors) of FDI to India

Chapter 6: Determinants of Outward FDI from India

The issues studied in this chapter are as follows:

- Theories of outward FDI
- Literature review and theoretical framework
- Empirical determination of the Push factors of FDI from India

Chapter 7: Summary, Conclusions and Recommendations

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