



**Review Article**

**GLOBALIZATION OF ECONOMY AND THE IMPACT OF FOREIGN DIRECT INVESTMENT ON  
SUSTAINABLE GROWTH: AN INDIAN PERSPECTIVE**

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**ARTICLE INFO**

**Article History:**

Received 05<sup>th</sup> December, 2014  
Received in revised form  
13<sup>th</sup> January, 2015  
Accepted 15<sup>th</sup> February, 2015  
Published online 31<sup>st</sup> March, 2015

**Key words:**

Foreign Direct Investment (FDI),  
Trans-National Corporation (TNC),  
Multi National Corporations (MNCs),  
MIGA (Multilateral Investment Guarantee  
Agency).

**ABSTRACT**

Investment in India provides the base and pre-requisite for economic growth and development. Apart from a nation's foreign exchange reserves, exports, government's revenue, financial position, available supply of domestic savings, magnitude and quality of foreign investment are necessary for the well being of a country. Developing nations, in particular, consider FDI as the safest type of international capital flows out of all the available sources of external finance available to them. FDI provides a win – win situation to the host and the home countries. Both countries are directly interested in inviting FDI because they benefit a lot from such type of investment. There is a considerable change in the attitude of both the developing and developed countries towards FDI. They both consider FDI as the most suitable form of external finance. FDI is a predominant and vital factor in influencing the contemporary process of global economic development. The present study is limited to assess the determinants of Foreign Direct Investment flows and its impact on Indian economy. It is concluded that the Government should design the FDI policy in such a way where FDI inflows can be utilized as means of enhancing domestic production, savings and exports through the equitable distribution among states so that they can attract FDI inflows at their own level. FDI can help to raise the output, production and export at the sectoral level of the Indian economy. It is advisable to open up the export oriented sectors and higher growth of economy could be achieved through the growth of these sectors. With the initiation of globalization, developing countries, particularly those in Asia, have been witnessing an immense surge of FDI inflows during the past two decades. Even though India has been a latecomer to the FDI scene compared to other East Asian countries, its considerable market potential and a liberalized policy regime has sustained its attraction as a favorable destination for foreign investors. This research paper aims to examine the impact of FDI on the Indian economy, particularly after two decades of economic reforms, and analyzes the challenges to position itself favorably in the global competition for FDI.

**Objectives:**

The research paper covers the following objectives:

- To study the trends and pattern of flow of FDI.
- To assess the determinants of FDI inflows.
- To evaluate the impact of FDI on the Indian economy.
- To know the flow of investment in India

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**INTRODUCTION**

Foreign Investment in India or more precisely Foreign Direct Investment (FDI) in India is one of the most talked about issues in the entire world economy in recent times.

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Rated among the top emerging nations, India's liberalization policies are paying rich dividends to the economy as a whole. Foreign Direct Investment (FDI) is defined as "investment made to acquire lasting interest in enterprises operating outside of the economy of the investor." The FDI relationship consists of a parent enterprise and a foreign affiliate which together form a Trans-National Corporation (TNC). India, post liberalization, has not only opened its doors to foreign

investors but also made investing easier for them by implementing the following measures:

- Foreign exchange controls have been eased on the account of trade.
- Companies can raise funds from overseas securities markets and now have considerable freedom to invest abroad for expanding global operations.
- Foreign investors can remit earnings from Indian operations.
- Foreign trade is largely free from regulations, and tariff levels have come down sharply in the last two years.
- While most Foreign Investments in India (up to 51 %) are allowed in most industries, foreign equity up to 100 % is encouraged in export-oriented units, depending on the merit of the proposal. In certain specified industries reserved for the small scale sector, foreign equity up to 24 % is being permitted now.

As the industry progresses, opportunities abound in India, which has the world's largest middle class population of over 300 million, is attracting foreign investors by assuring them good returns. The scope for foreign investment in India is unlimited. India offers to foreign investors a well balanced package of fiscal incentives for exports and industrial investments that includes:

- Complete tax exemptions.
- Investment incentives are offered by both the Central Government and the Government of the State in which the unit is located.
- India has tax treaties with 40 countries.

Moreover, the support of the common man regarding FDI is clearly from the sharp hike in India's gross expenditure in the past few years. Thus the Indian economy is proving itself highly conducive to Foreign Investment. One of the most striking developments during the last two decades is the spectacular growth of FDI in the global economic landscape. This unprecedented growth of global FDI around the world make FDI an important and vital component of development strategy in both developed and developing nations and policies are designed in order to stimulate inward flows. Both countries are directly interested in inviting FDI, because they benefit a lot from such type of investment. The 'home' countries want to take the advantage of the vast markets opened by industrial growth. On the other hand the 'host' countries want to acquire technological and managerial skills and supplement domestic savings and foreign exchange. Moreover, the paucity of all types of resources viz. financial, capital, entrepreneurship, technological know-how, skills and practices, access to markets- abroad- in their economic development, developing nations accepted FDI as a sole visible panacea for all their scarcities. Further, the integration of global financial markets paves ways to this explosive growth of FDI around the globe.

### **FDI and Indian Economy**

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 of Britain in India. However, researchers could not portray the complete history of FDI pouring in India due to lack of abundant and authentic data. Before independence major amount of FDI came from the British companies. British companies setup their units in mining sector and in those sectors that suits their own economic and business interest. After Second World War, Japanese companies entered Indian market and enhanced their trade with India, yet U.K. remained the most dominant investor in India. Further, after Independence issues relating to foreign capital, operations of MNCs, gained attention of the policy makers. Keeping in mind the national interests the policy makers designed the FDI policy which aims FDI as a medium for acquiring advanced technology to mobilize foreign exchange resources. The first Prime Minister of India considered foreign investment as "necessary" not only to supplement domestic capital but also to secure scientific, technical, and industrial knowledge and capital equipments. With time and as per economic and political regimes there have been changes in the FDI policy too. The industrial policy of 1965, allowed MNCs to venture through technical collaboration in India. However, the country faced two severe crisis in the form of foreign exchange and financial resource mobilization during the second five year plan (1956 -61).

Therefore, the government adopted a liberal attitude by allowing more frequent equity participation to foreign enterprises, and to accept equity capital in technical collaborations. The government also provides many incentives such as tax concessions, simplification of licensing procedures and de-reserving some industries such as drugs, aluminium, heavy electrical equipments, fertilizers, etc in order to further boost the FDI inflows in the country. This liberal attitude of government towards foreign capital lures investors from other advanced countries like USA, Japan, and Germany, etc. But due to significant outflow of foreign reserves in the form of remittances of dividends, profits, royalties etc, the government has to adopt stringent foreign policy in 1970s. During this period the government adopted a selective and highly restrictive foreign policy as far as foreign capital, type of FDI and ownerships of foreign companies was concerned. Government setup Foreign Investment Board and enacted Foreign Exchange Regulation Act in order to regulate flow of foreign capital and FDI flow to India. The soaring oil prices continued low exports and deterioration in Balance of Payment position during 1980s forced the government to make necessary changes in the foreign policy.

It is during this period the government encourages FDI, allow MNCs to operate in India. Thus, resulting in the partial liberalization of Indian Economy. The government introduces reforms in the industrial sector, aimed at increasing competency, efficiency and growth in industry through a stable, pragmatic and non-discriminatory policy for FDI flow. In fact, in the early nineties, Indian economy faced severe Balance of payment crisis. Exports began to experience serious difficulties. There was a marked increase in petroleum prices because of the gulf war. The crippling external debts were debilitating the economy. India was left with that much amount of foreign exchange reserves which can finance its three weeks of imports. The out flowing of foreign currency which was deposited by the Indian NRI's gave a further jolt to

Indian economy. Inflation reached at its highest level of 13%. Foreign reserves of the country stood at Rs.11416 crores. The continued political uncertainty in the country during this period adds further to worsen the situation. As a result, India's credit rating fell in the international market for both short-term and long term borrowing. All these developments put the economy at that time on the verge of default in respect of external payments liability. In this critical face of Indian economy the then finance Minister of India Dr. Manmohan Singh with the help of World Bank and IMF introduced the macro – economic stabilization and structural adjustment program. As a result of these reforms India open its door to FDI inflows and adopted a more liberal foreign policy in order to restore the confidence of foreign investors. Further, under the new foreign investment policy Government of India constituted FIPB (Foreign Investment Promotion Board) whose main function was to invite and facilitate foreign investment through single window system from the Prime Minister's Office. The foreign equity cap was raised to 51 percent for the existing companies. Government had allowed the use of foreign brand names for domestically produced products which was restricted earlier. India also became the member of MIGA (Multilateral Investment Guarantee Agency) for protection of foreign investments.

Government lifted restrictions on the operations of MNCs by revising the FERA Act 1973. New sectors such as mining, banking, telecommunications, highway construction and management were open to foreign investors as well as to private sector. India's Foreign Direct Investment (FDI) policy has been gradually liberalised to make the market more investor friendly. The results have been encouraging. These days, the country is consistently ranked among the top three global investment destinations by all international bodies, including the World Bank, according to a United Nations (UN) report. For Indian economy which has tremendous potential, FDI has had a positive impact. FDI inflow supplements domestic capital, as well as technology and skills of existing companies. It also helps to establish new companies. All of these contribute to economic growth of the Indian Economy. The Multilateral Investment Guarantee Agency (MIGA), the political risk insurance and credit enhancement arm of the World Bank Group, announced strong results for the fiscal year ending June 30, 2014.

A record high of \$3.2 billion in new insurance underpins foreign direct investment that is expected to catalyze a further \$2.6 billion in investment, create 7,500 jobs, generate enough power for 26 million people in countries in need of energy, improve infrastructure, and generally support economies in developing countries around the world. New business saw an uptick of 13 percent over the previous year. Investments that MIGA insured this year span all regions across a broad range of sectors, including power, manufacturing, agribusiness, financial services, telecommunications, and transportation. The Agency broke new ground with the first use of its credit enhancement product for a bond issue (by Hungary's Exim Bank)-an innovative example of capital markets investing in developing countries. Addressing developing countries' energy deficit was a strong focus of MIGA's business this year. MIGA's support included coverage of private-equity firm Actis' investments in three projects that will supply a quarter

of Cameroon's electricity; the Agency's first project in Lebanon, which will play a large role in transforming the country's struggling power sector; and Cerro de Hula wind farm in Honduras that will supply cheaper, clean, and renewable energy in one of Latin America's poorest countries.

MIGA's partnership with the Overseas Private Investment Corporation (OPIC - the U.S. development finance institution) to mobilize private equity funds that will support over a half a million small farmers in sub-Saharan Africa was also a notable development this year. "We are privileged to serve private investors operating in developing countries by insuring \$3.2 billion in projects that we expect will create 7,500 jobs and generate enough power for 26 million people in countries experiencing energy deficits," said Keiko Honda, MIGA's Executive Vice President and CEO. "We seek to better serve private investors and developing countries with our political risk insurance and credit enhancement products." She added, "We expect to continue to be innovative in applications of our products-like their use to bolster capital market transactions and private equity." During the fiscal year MIGA also launched a new strategy to align with the World Bank Group's goals of ending extreme poverty and boosting shared prosperity. The Agency will work in tandem with the World Bank and IFC on a country basis to identify high-impact projects and collaborate with national governments to reach their development objectives.

### **Current Challenges and Improvement Areas**

India is definitely a lucrative place for FDI, but there are certainly some challenges and areas for improvement still present. Until, these areas are honed to perfection, India will not become the number one place for FDI. India is focusing on maximizing political and social stability along with a regulatory environment. In spite of the obvious advantages of FDIs, there are quite a few challenges facing larger FDIs in India, such as:

#### **Resource challenge**

India is known to have huge amounts of resources. There is manpower and significant availability of fixed and working capital. At the same time, there are some underexploited or unexploited resources. The resources are well available in the rural as well as the urban areas. The focus is to increase infrastructure 10 years down the line, for which the requirement will be an amount of about US\$ 150 billion. This is the first step to overcome challenges facing larger FDI.

#### **Equity challenge**

India is definitely developing in a much faster pace now than before but in spite of that it can be identified that developments have taken place unevenly. This means that while the more urban areas have been tapped, the poorer sections are inadequately exploited. To get the complete picture of growth, it is essential to make sure that the rural section has more or less the same amount of development as the urbanized ones. Thus, fostering social equality and at the same time, a balanced economic growth.

## Political Challenge

The support of the political structure has to be there towards the investing countries abroad. This can be worked out when foreign investors put forward their persuasion for increasing FDI capital in various sectors like banking, and insurance. So, there has to be a common ground between the Parliament and the Foreign countries investing in India. This would increase the reforms in the FDI area of the country.

## Federal Challenge

Very important among the major challenges facing larger FDI, is the need to speed up the implementation of policies, rules, and regulations. The vital part is to keep the implementation of policies in all the states of India at par. Thus, asking for equal speed in policy implementation among the states in India is important.

## Conclusion

Inward FDI has boomed in post-reform India. At the same time, the composition and type of FDI has changed considerably. Even though manufacturing industries, too, have attracted rising FDI, the services sector accounted for a steeply rising share of FDI stocks in India. 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. For the Indian economy as a whole, we find that FDI stocks and output are co integrated in the long run. However, the impact of output growth in attracting FDI is relatively stronger than that of FDI in inducing economic growth. In other words, causation is mainly running from output growth to FDI stocks. Most interestingly, and contrary to the widespread view that booming FDI in the services sector is driving growth in India, feedback effects between FDI and output turn out to be transitory in this sector. If at all, causality in the services sector runs from output to FDI in the long run. It may be tempting to conclude from the sector-specific results that the pre reform approach to FDI in India was not so bad after all. Traditionally, selective approval procedures and performance requirements were meant to promote FDI in technologically advanced and more export-oriented manufacturing industries, and to discourage FDI in the tertiary sector where foreign investors might replace local service providers.

However, such a conclusion would be misconceived. Our results do support the view that the quality of FDI matters at least as much as the volume of FDI for the growth implications in host economies. More specifically, our results are in line with findings of cross country analyses according to which the growth implications depend on various factors, including absorptive capacity and local skills, technological spillovers and linkages between foreign and local firms, and export orientation – all of which may differ across industries and sectors in the host economy. Yet all this does not speak in favor of selective FDI policies and policymakers attempting to target preferred types of FDI in specific industries. For such an approach to be successful in attracting growth-promoting FDI, policymakers would have to know exactly about the quality of each FDI proposal and its effects on the local economy. This

appears to be an overly heroic assumption. Otherwise, it would be difficult to explain why earlier studies on the FDI-growth nexus in India, the results of which should be shaped more strongly by pre-reform selectivity and targeting, do not produce “better” results than the present study. On the other hand, our results clearly suggest that the currently prevailing euphoria about FDI in India rests on weak empirical foundations. FDI is unlikely to work wonders if only remaining regulations were relaxed and still more industries opened up to FDI. This is not to ignore that policymakers may contribute to maximizing the benefits of FDI in India. Their contribution has less to do with specific FDI policies. Rather, the policy challenge is to improve local conditions that may render FDI more effective. Openness to trade and financial sector development seem to be important in this regard. The same applies to the promotion of local entrepreneurship and human capital development.

This is even though India is widely acclaimed for its entrepreneurship and highly skilled workforce. However, these undisputable achievements seem to be highly concentrated in a few clusters, both region-wise and industry-wise, whereas large parts of the economy provide by far less favorable conditions for FDI to have stronger growth effects. India’s Foreign Direct Investment (FDI) policy has been gradually liberalised to make the market more investor friendly. The results have been encouraging. These days, the country is consistently ranked among the top three global investment destinations by all international bodies, including the World Bank, according to a United Nations (UN) report. For Indian economy which has tremendous potential, FDI has had a positive impact. FDI inflow supplements domestic capital, as well as technology and skills of existing companies. It also helps to establish new companies. All of these contribute to economic growth of the Indian Economy India must also focus on areas of poverty reduction, trade liberalization, and banking and insurance liberalization. Challenges facing larger FDI are not just restricted to the ones mentioned above, because trade relations with foreign investors will always bring in new challenges in investments.

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