

CHAPTER II

FDI POLICY, TRENDS AND PATTERNS OF INFLOWS

2.1 INTRODUCTION

Liberalization moves of developing countries in eighties in general and adoption of liberal policy regimes for attracting FDI in particular have been driving global regional FDI flows to these countries. Apart from the obvious benefits of capital inflows, such as, supplementing domestic savings and investments and generation of employment and income, it is the transfer of new technology and management skills from parent firms to the foreign affiliates in the host country, which probably stands as the most justifiable and valid ground for initiation of a liberal policy towards FDI. It is in this backdrop that an enabling policy framework, put in a broad and transparent manner, and its effective implementation play a crucial role in not only attracting FDI but also reaping the maximum benefits from it, in terms of enhancing the efficiency of resource-use and economic growth and, hence, the overall development of the national economy.

The policy towards foreign investment in India has undergone a change, from a more restrictive FDI policy to a liberal FDI policy, since the introduction of the economic reforms in July 1991. The NIP, announced on July 24, 1991, marks a historic change in India's economic mindset towards industrial development and liberalization of FDI policy. Within this broad framework, FDI has been recognized as a crucial supplementing input for ushering a vibrant, efficient and competitive industrial sector in India. The policy statement has clarified India's stand on liberalizing the FDI policy, while emphasizing the importance of FDI in increasing the efficiency of the industrial sector through several attendant advantages that the FDI brings in forms of technology transfer, marketing

expertise, introduction of modern management techniques and new possibilities for promotion of exports. The FDI policy statement under NIP 1991 thus explicitly underscores the relative merits of FDI in promoting India's economic growth and development.

In pursuance of first objective of the study, rest of this chapter contains the following. (a) Trends and patterns of global FDI regional flows and its importance in inter regional inflows from the perspective of developing countries. (b) An account of the evolution of FDI policy since independence, with a special focus on FDI policy since the introduction of economic reforms in 1991. (c) A detail analysis of the trends and patterns of FDI inflows to India since 1991.

2.2. GLOBAL FDI TRENDS AND PATTERNS OF FLOWS

The importance of FDI as an instrument of economic development and growth was felt immensely after world debt crisis of 1980s. Gradual decline of non-equity sources of foreign capital gave further impetus to non-debt creating foreign capital, which comes in the form of equity investment viz., FDI and Foreign Portfolio Investment (FPI). Besides, most important drivers of the FDI and internationalization of production network owes to the increasing globalization of firms consequent on the liberalization moves of most of the countries, especially developing countries and advent of information and communication technology.

2.2.1 Trends of Global FDI flows

Global regional flows of FDI have witnessed manifold growth during the period from 1991 to 1998, representing a more than quadruple increase from a level of US \$158.94 billion in 1991 to US \$690.91 billion in 1998 and recording an average annual growth of 23.77 percent (Table 2.1)¹. A major share of FDI flows, nearly 62 percent during the entire period was flown to developed countries, leaving about 34 percent to developing countries. Developing countries' share showed a steady improvement during the above period, which increased from about 26 percent in 1991 to a high of 41 percent in 1994 and 28 percent in 1998. The declining developed countries' share of FDI flows during the period from 1991 to 1998 could be attributable to locational shift of the business activities of Transnational Corporations (TNCs) to developing countries. The implications of decreasing share of FDI flows into developed countries and its consequent increase of FDI flows to developing countries was far-reaching and more desirable from the viewpoint of convergence of economic growth across countries. TNCs, which function as the major source of the carriers of the cross-border composite bundle of tangible and intangible capital, the increasing trend of FDI from developed countries to developing countries could serve to a greater extent in closing the 'objects and ideas gaps' that a developing country might have in the process of economic development, thereby, facilitating convergence of economic growth and bridging the gap between developed and developing countries (Romer, 1993). FDI flows to developing countries as a group, when compared with all other capital flows, constituted a major component, accounted for more than 72 percent of all resource flows (UNCTAD, 2004).

¹ Unless stated otherwise, all variables in this chapter refer to current prices.

Table 2.1: Trends in Global Regional Inflows of FDI (1991 to 1998)

		(In Billion US \$)								
Region \ Year	1991	1992	1993	1994	1995	1996	1997	1998	(1991-98)	
Total Inflows	158.94	175.84	219.42	255.99	331.07	384.91	477.92	690.91	2694.99	
Developed Countries	114.79	120.29	133.85	145.14	203.46	219.69	271.38	472.55	1681.14	
% Share in total	72.23	68.41	61.00	56.70	61.46	57.08	56.78	68.40	62.38	
Developing Countries	41.70	51.11	78.81	104.92	113.34	152.49	187.35	194.06	923.78	
% Share in total	26.23	29.06	35.92	40.99	34.23	39.62	39.20	28.09	34.28	
<i>Of which</i>										
Latin America & the Caribbean	9.46	17.61	20.01	30.09	32.31	51.28	71.15	82.49	314.40	
% Share in developing countries	22.69	34.46	25.39	28.68	28.51	33.63	37.98	42.51	34.03	
Central & Eastern Europe	2.45	4.44	6.76	5.93	14.27	12.73	19.19	24.31	90.07	
% Share in developing countries	5.87	8.69	8.57	5.65	12.59	8.35	10.24	12.52	9.75	
Asia	23.13	29.65	54.84	68.61	75.29	94.35	107.21	102.21	555.28	
% Share in developing countries	55.47	58.02	69.58	65.39	66.43	61.87	57.22	52.67	60.11	

Trends in Global Regional Inflows of FDI (1999 to 2003)

		(In Billion US \$)					
Region \ Year	1999	2000	2001	2002	2003	1999-03	
Total Inflows	1086.8	1388.0	817.6	678.8	559.6	4530.6	
Developed Countries	828.4	1108.0	571.5	489.9	366.6	3364.3	
% Share in total	76.22	79.83	69.90	72.18	65.51	74.26	
Developing Countries	231.9	252.5	219.7	157.6	172.0	1033.7	
% Share in total	21.3	18.2	26.9	23.2	30.7	22.8	
<i>Of which</i>							
Latin America & the Caribbean	107.4	97.5	88.1	51.4	49.7	394.2	
% Share in Developing Countries	46.32	38.63	40.11	32.59	28.90	38.13	
Central & Eastern Europe	24.31	26.52	27.51	26.37	31.23	20.97	
% Share in Developing Countries	10.48	10.50	12.52	16.73	18.15	2.03	
Asia	112.6	146.1	111.9	94.4	107.1	572.0	
% Share in Developing Countries	48.55	57.86	50.91	59.88	62.27	55.34	

Notes: (a) Classification of developing countries is as per the UNCTAD

(b) Percentage share may not sum up to 100 due to reporting errors.

Source: UNCTAD, World Investment Report, United Nations, various issues.

Within the developing countries, FDI flows to Asian countries remained dominant throughout, which rose from a mere US \$23 billion in 1991 to US \$102 billion in 1998, representing an annual average growth of 26 percent and a percentage share of around 60 percent in developing countries' FDI inflows during the entire period. The growth momentum of global FDI flows continued till 2000 touching a high level of US \$1388 billion and thereafter it registered a slowdown to US \$818 billion in 2001 and further to US \$560 billion in 2003. During the later period from 1999 to 2003, share of FDI flows in developing countries declined to 23 percent compared to 34 percent during the period from 1991 to 1998. Nevertheless the share of Asian countries maintained the maximum percentage share in developing countries' total inflows, though it declined to 55 percent in the period from 1999 to 2003 compared to 60 percent during the period from 1991 to 1998. Several micro, macro and institutional factors were responsible for the continued decline in inward FDI flows during 2001-2003 (UNCTAD, 2003). During the period growth prospects for many countries remained uncertain including performance of major stock markets, which stayed below the peak of 2000. At micro-level, lowered profitability coupled with high debt-equity ratio continued to force large companies to downsize their operations. All these factors pulled down merger & acquisitions (M&As), which were dominant factors for increased FDI flows, to a lower level and ultimately reflecting lower level of global FDI flows during the period.

While countries like Brazil and Mexico in Latin American and Caribbean received the maximum percentage shares of FDI flows in developing countries, accounting for 7.66 percent each respectively during the period from 1991 to 1998 (Table 2.2), China emerged as the top recipient of FDI flows in Asian countries, with a percentage share of 26.26 percent in developing countries' total

FDI flows (Table 2.3). Other Asian countries, like, Hong Kong and Singapore received 6.28 percent and 6.37 percent respectively during the above period. Percentage share of India in developing countries' total FDI flows in the region was higher as compared to the countries, like, Philippines and Taiwan, with a 1.40 percent during the period. In the later period from 1999 to 2003, while percentage shares of other countries, like, Argentina, Chile, Colombia, Peru, Venezuela in Latin American and Caribbean registered a decline, shares of Brazil and Mexico increased to 10.69 percent and 7.94 percent respectively during the period. During the period from 1999 to 2003, percentage share of China in developing countries total FDI flows declined to 22.65 percent compared to 26.26 percent during the period from 1991 to 1998. The relative decline in China's share in developing countries total FDI flows during the later period could be attributed to the emerging FDI recipient countries in the region like, Hong Kong, South Korea, Taiwan and India. India's share during the period moved up to 1.51 percent compared to 1.40 percent during 1991 to 1998.

Emergence of China as the top FDI recipient among developing countries and second largest recipient of FDI flows after the USA continued as a top FDI destination. During 2003, inward FDI flows to China was highest amongst all countries, with a total inflow of US \$ 53.51 billion compared to the USA's \$ 29.77 billion. The success of China in becoming one of the major FDI destinations was attributed to its large and burgeoning domestic market and its entrenched macroeconomic reform (UNCTAD, 1997). The success of Asian countries in attracting FDI lies in an investment climate characterized by growing markets and favorable regulatory frameworks (UNCTAD, 1995). India and China share many similarities in terms of market sizes and advantageous cheap skilled labour force imbued with huge potential for future growth.

Table 2.2: Share of FDI inflows in Developing Countries' Total: Select Latin America & Caribbean Countries (1991 to 1998)

	(In Percent)									
	1991	1992	1993	1994	1995	1996	1997	1998	(1991-98)	
Argentina	2.80	7.91	3.51	3.33	4.95	4.56	4.89	3.76	4.38	
Brazil	3.02	4.03	1.64	2.47	4.83	6.88	10.00	14.87	7.66	
Chile	1.83	1.37	1.31	2.60	2.61	3.04	2.79	2.38	2.45	
Colombia	1.09	1.43	1.22	1.38	1.17	1.23	1.57	1.46	1.36	
Mexico	7.39	8.60	8.52	10.46	8.40	6.49	7.39	6.35	7.66	
Peru	0.07	0.27	0.87	2.94	1.81	2.13	0.91	0.85	1.36	
Venezuela	1.08	1.23	0.47	0.77	0.87	1.43	2.95	2.57	1.73	

Share of FDI inflows in Developing Countries' Total: Select Latin America & Caribbean Countries (1999 to 2003)

	(In Percent)					
	1999	2000	2001	2002	2003	1999-03
Argentina	10.35	4.13	0.99	0.50	0.28	3.66
Brazil	12.32	12.98	10.22	10.53	5.90	10.69
Chile	3.78	1.93	1.91	1.20	1.73	2.20
Colombia	0.65	0.95	1.15	1.34	1.02	1.00
Mexico	5.70	6.57	12.19	9.36	6.27	7.94
Peru	0.84	0.32	0.52	1.37	0.80	0.72
Venezuela	1.25	1.86	1.68	0.49	1.47	1.41

Note: Classification of developing countries is as per the UNCTAD

Source: UNCTAD, World Investment Report, United Nations, various issues.

**Table 2.3: Share of FDI inflows in Developing Countries' Total:
Select Asian Countries (1991 to 1998)**

	(In Percent)								
	1991	1992	1993	1994	1995	1996	1997	1998	(1991-98)
China	10.47	21.83	34.91	32.20	31.63	26.35	23.61	23.43	26.26
Hong Kong, SAR	4.10	4.01	4.64	7.46	5.48	6.86	6.07	7.61	6.28
Indonesia	1.79	3.48	2.54	2.01	3.83	4.06	2.50	-0.12	2.34
Korea, Republic of	2.07	1.42	0.75	0.94	1.57	1.52	1.52	2.60	1.64
Malaysia	3.85	10.14	6.35	4.37	5.13	4.78	3.48	1.40	4.19
Philippines	1.20	0.45	1.57	1.52	1.29	1.00	0.67	1.14	1.08
Singapore	8.61	4.31	5.95	8.15	7.75	6.80	6.92	3.96	6.37
Taiwan	2.48	1.72	1.16	1.31	1.38	1.22	1.20	0.11	1.09
Thailand	3.18	4.14	2.29	1.28	1.77	1.49	1.94	3.86	2.38
India	0.42	0.46	0.73	0.93	1.89	1.70	1.93	1.36	1.40

**Share of FDI inflows in Developing Countries' Total:
Select Asian Countries (1999 to 2003)**

	(In Percent)					
	1999	2000	2001	2002	2003	1999-03
China	17.39	16.13	21.34	33.46	31.10	22.65
Hong Kong, SAR	10.60	24.53	10.82	6.14	7.88	12.92
Indonesia	-0.80	-1.80	-1.35	0.09	-0.35	-0.95
Korea, Republic of	4.07	3.40	1.68	1.87	2.18	2.75
Malaysia	1.68	1.50	0.25	2.03	1.44	1.35
Philippines	0.74	0.53	0.45	1.14	0.19	0.60
Singapore	6.93	6.82	6.84	3.64	6.63	6.33
Taiwan	1.26	1.95	1.87	0.92	0.26	1.34
Thailand	2.63	1.33	1.74	0.68	1.05	1.56
India	0.93	0.92	1.55	2.19	2.48	1.51

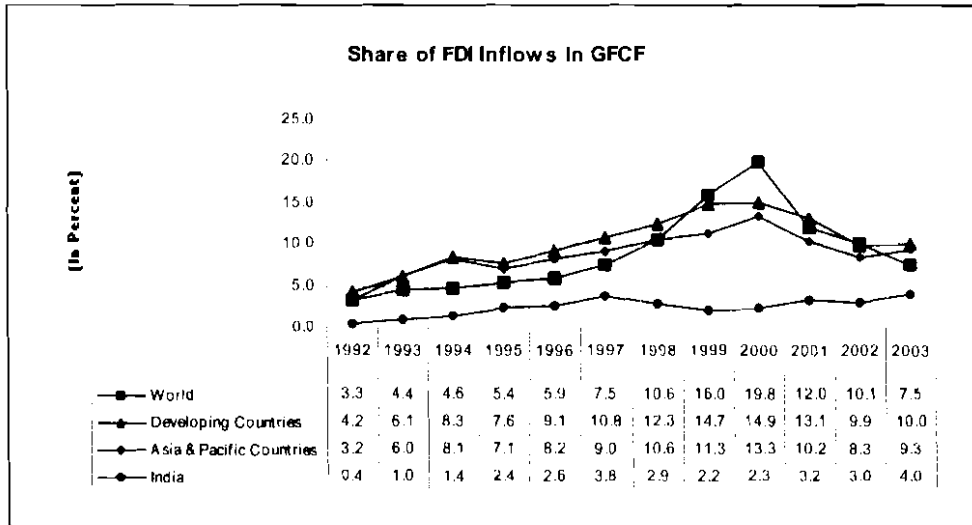
Note: Classification of developing countries is as per the UNCTAD

Source: UNCTAD, World Investment Report, United Nations, various issues.

2.2.2 Global Regional FDI Flows And Gross Fixed Capital Formation

A ratio of inward FDI flows to gross domestic fixed capital formation (GDFC) in a given year is a measure of the relative contribution of FDI to the total fixed assets/investments, domestic and foreign, in a country. The ratio is indicative of the role of FDI in domestic fixed capital formation. The global regional inflows of FDI as percentage to global gross fixed capital formation showed a consistent improvement from 3.3 percent in 1992 to a peak of 19.8 percent in the year 2000 and thereafter it declined to 12 percent in 2001 and 7.5 percent in 2003 as a result of global slowdown in FDI flows (Figure 2.1). During the period from 1992 to 1998, the ratio of FDI inflows to GDFC for developing countries rose from 4.2 percent in 1992 to 12.3 percent in 1998 and stayed above the global ratio throughout and thereafter it moved in tandem with global ratio, indicating its relative importance as a prime contributor to their fixed capital formation. Even for Asia and Pacific countries, the ratio showed consistent improvement over the period and moved along with the developing countries. India exhibited steady improvement, though at a very low level, in its FDI contribution to its GDFC. At 0.4 percent in 1992, the ratio moved up to 2.9 percent in 1998 and stood a maximum of 4 percent in 2003.

Figure 2.1: Share of inward FDI inflows in Gross Fixed Capital Formation



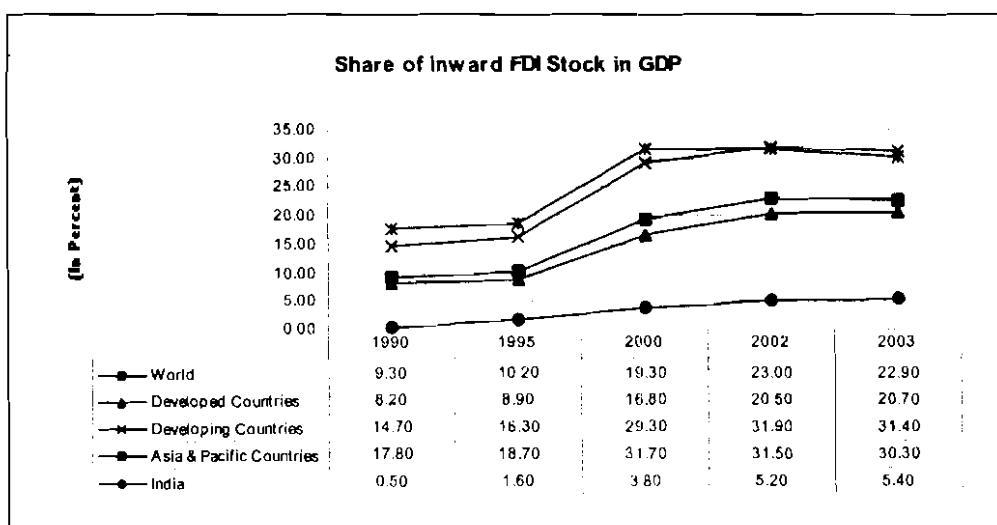
Source: World Investment Report, United Nations, various issues.

2.2.3 Inward FDI Stock And Gross Domestic Product

Inward FDI stock as a percentage to gross domestic product (GDP) is another indicator by which one can gauge the cumulative FDI absorption relative to the size an economy. It also signifies the relative openness of an economy *vis-à-vis* its other competing countries and groups of countries. As most countries differ in their economic sizes measured by value of GDP, percentage of FDI stock to GDP also provides an indication of the relative absorptive FDI capacity of the economy in comparison to ratios of regional FDI stocks in various groups of countries and other competing countries. At global level, share of FDI stock in GDP progressively rose from 9.30 percent in 1990 to 22.90 percent in 2003, indicating the relative importance of FDI and increasing internationalization of production network amongst TNCs (Figure 2.2). More importantly, percentage share of developing countries' FDI stock in their combined GDP stayed above the global ratio as well as developed countries throughout the period, signifying a

greater role of FDI that it continued to play in developing countries *vis-à-vis* their developed counterparts. Percentage share of FDI stock in GDP of developing countries, which was 14.70 percent against 8.20 percent for developed countries in 1990, progressively rose to 31.40 percent compared to 20.70 percent for developed countries in 2003. For Asia and Pacific countries, the above ratio stood highest at 17.80 percent in 1990, which also marked a steady rise to around 31 percent in 2003, clearly indicating TNCs' preferred destination for FDI. Increasing stock of FDI in GDP of Asia and Pacific also showed the increasing FDI destination of a single country, namely, China. India, though fared reasonably well in its stock of FDI as percentage to its GDP, yet the ratio reveals its untapped FDI absorption capacity. India's share of FDI stock in its GDP rose from a meager 0.5 percent in 1990 to 1.60 percent in initial reform period and to 5.40 percent in 2003. Going by the developing countries' trends, India's FDI absorptive capacity was as much as four times its FDI stock of US \$30.83 billion in 2003.

Figure 2.2: Share of Global Inward FDI stock in Gross Domestic Product



Source: World Investment Report, United Nations, various issues.

2.2.4 Inward FDI Performance Index

United Nations Conference on Trade and Development (UNCTAD) has been bringing out an inward FDI performance index for comparing relative performance of countries in attracting FDI. The measure is a ratio of share in global inward FDI flows of a country to its global share in GDP². There are a large number of other variables, which influence the FDI inflows to an economy, yet these factors' influence may vary under varying degree of openness and regimes³. Under similar conditions, the size of the economy can be a major determinant of FDI. Value of index, which ranges between greater and lesser than one, indicates countries' power of receiving higher amount of FDI relative to its size and countries receiving lesser amount of FDI relative to its size respectively. However, a negative value of the index, which is an infrequent occurrence, can mean the disinvestments by TNCs during the year. Countries are ranked as per the value of the index⁴.

² Methodology for constructing inward FDI performance index in World Investment Report, 2002 is as follows. $IND_i = [(FDI_i)/(FDI_w)] / [(GDP_i)/(GDP_w)]$ where IND_i = Inward FDI Performance Index of the i th country, FDI_i = FDI inflows in the i th country, FDI_w = World FDI inflows, GDP_i = GDP in the i th country and GDP_w = World GDP.

³ A host of other factors can be a part in determining FDI inflows. These factors, which are diverse and often difficult to quantify, can be business environment with investment facilitation, labour laws, enforcement of contracts, coordination of various agencies, geographic location, availability of skilled labour, infrastructure and availability of natural resources and most important among all the political & economic stability with continuity and emphasis on economic policies.

⁴ In the World Investment Report, inward FDI performance index is reported by taking a three-year moving average to smooth out annual fluctuations of FDI flows for 140 countries (24 developed countries; 99 developing economies; and 17 Central and Eastern Europe economies). It excludes tax havens. Tax havens are the countries, which attract FDI to take advantage of the benefits of tax rather than going by the size and other economic determinants of FDI. Such tax heaven, for example, can be Mauritius, which attracts the FDI with a view of its onward investments in India so as to gain tax advantage.

While FDI performance index of developed countries as a group declined 0.92 during 2001-2003, index for developing countries increased to 1.25 during the same period, with value of FDI performance index for Asia above one at 1.25 (UNCTAD, 2004). As evident from Table 2.4, India's FDI performance index value showed consistent improvement from 0.066 during 1988-1990 to 0.160 during 1998-2000 and further to 0.357 during 2001-2003. India ranked 114 in a total of 140 selected countries considered for FDI performance index computation by UNCTAD. Progressive improvement in India's FDI performance index does reflect its course of FDI policy changes from a protectionist policy regime existed before 1991 and gradual openness in FDI policy that India adopted between 1991 and 2003. The ranking of countries also revealed that most of the developed countries, e.g., USA ranked lower and small countries like Malaysia, Singapore recorded higher value in the FDI performance index. Such anomalies occur because of the larger size of the economies (in terms of its GDP share in global GDP). Most of the developed countries are homes of the TNCs and are seen as the major supplier of FDI (outward FDI being larger than the inward FDI flows) amongst themselves and other developed countries. However, it also reflects the country's FDI absorption capacity.

**Table 2.4: Inward FDI Performance Index
UNCTAD Rankings of Countries: India (2001-2003)**

Rank*	Countries	Value		
		1988-1990	1998-2000	2001-2003
111	Ethiopia	0.060	0.707	0.399
112	United States	1.115	0.815	0.396
113	Uzbekistan	N.A	0.216	0.360
114	India	0.066	0.160	0.357
115	Kyrgyzstan	N.A	1.047	0.352
116	Libyan Arab Jamahiriya	0.507	-0.121	0.352
117	Taiwan Province of China	0.927	0.275	0.350

Notes: (a) * Ranked by the index for 2001-2003

(b) FDI Performance Index is the ratio of a country's share in global FDI flows to its share in global GDP

(c) N.A. refers to not available

Source: UNCTAD, World Investment Report, 2004, www.unctad.org/fdistatistics

2.2.5 Inward FDI Potential Index

UNCTAD brings out inward FDI potential index. It is an index to compare the potentialities of various countries to attract FDI. Inward FDI potential index, comprising mainly of structural variables, is by far an improved measure of FDI potentiality by taking as many as 12 socio-economic crucial variables besides the size of the market determining the volume of FDI inflows into a country⁵. Countries are ranked by value of the index computed through a composite score⁶.

⁵ Variables included in computing FDI potential index are: (1) average real GDP growth for last ten years (2) per capita GDP (3) Total exports as percentage to GDP (4) Telephones and Mobiles per 1000 inhabitants (5) per capita energy use (6) R&D expenditure as percentage to GDP (7) Students at the tertiary level as percentage of total population (8) country risk (9) percentage share of exports of natural resources in world exports (10) percentage share of imports of parts/accessories of electronics and automobiles (11) percentages share of services exports in world services exports and (12) percentage share of inward FDI stock in world inward FDI stock.

⁶ Like inward FDI performance index, the Inward FDI Potential Index is averaged (three year period moving average) to smooth out annual fluctuations in data. Indices are reported for 140

Across different groups of countries, developed countries' potentiality to attract FDI stayed above the developing countries as a group throughout the period from 1988-1990 to 2000-2002 (UNCTAD, 2004). Index for developed countries, which was 0.374 during 1988-1990, moved up to 0.396 during 2000-2002. Developing countries also showed a steady climb of their inward FDI potentiality index from 0.138 during 1988-1990 to 0.177 during 2000-2002. The USA remained in the first place throughout the period 1988-2002 (UNCTAD, 2004). India improved its rank to 89th position during 2000-2002, with its value of the index featuring a continuous improvement from 0.120 during pre-reform period (1988-1990) to 0.149 during 1998-2000 and to 0.159 during 2000-2002 in the post reform period (Table 2.5). China, the largest recipient of FDI in the developing world, was positioned 39th by the FDI potential ranking. Compared to its economy's size, India lags behind many countries and several countries in the East Asia. Compared to FDI performance index, many large economies fared well in the FDI potentiality indices. While China's FDI inflows were higher than USA in recent years, in terms of potentiality index, USA still maintained the top FDI destination by various socio-economic variables.

countries (24 developed countries; 99 developing economies; and 17 Central and Eastern Europe economies), excluding tax havens, which tend to receive massive FDI inflows rather than their economies' size and other structural determinants.

**Table 2.5: Inward FDI Potential Index
UNCTAD Rankings of Countries: India (2000-2002)**

Rank*	Countries	Value		
		1988-1990	1998-2000	2000-2002
86	Angola	0.126	0.140	0.162
87	Yemen	0.068	0.157	0.161
88	Uzbekistan	N.A	0.158	0.161
89	India	0.120	0.149	0.159
90	Uruguay	0.145	0.200	0.159
91	El Salvador	0.107	0.174	0.159
92	Suriname	0.177	0.166	0.159

Notes: (a) * Ranked by the index for 2001-2003.

(b) FDI Performance Index is the ratio of a country's share in global FDI flows to its share in global GDP

(c) N.A. refers to not available

Source: UNCTAD, World Investment Report, 2004, www.unctad.org/fdistatistics

2.3 EVOLUTION OF FDI POLICY IN INDIA

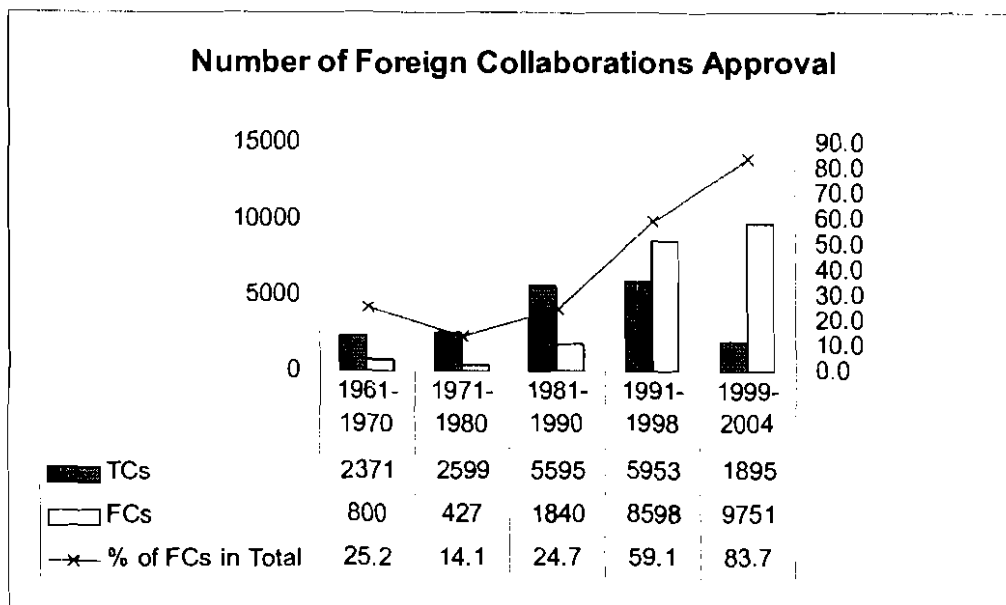
FDI policy adopted by India since independence is reviewed below, with a special focus on FDI policy initiated during 1991 and thereafter. The review is done with an intention to understand historically the evolution of foreign investment policy in India. Nearly more than four decades, India's policy towards FDI remained more or less selective, with varying degree of restrictions on foreign collaborations (Kidron, 1965; Goyal 1979). The entire period from post-independence India till onset of the new economic reforms, India's policy towards FDI or 'foreign collaborations' underwent different phases and can be divided into four different phases, which characterize different policy attitudes adopted towards FDI in each period. Phase I (1948-1967) represented cautious and selective attitude; Phase II (1968-1979) marked intensive restriction; Phase III (1980-1990) initiated a partial liberalization; and Phase IV (1991 and onwards) began a full-fledged liberalization process with introduction of reforms during 1991 and subsequent modifications brought about thereafter (Kumar, 1998). FDI

policies in these periods were shaped by multiple national economic objectives, such as, self-reliance, creation and protection of national assets by way of setting up of heavy industries under 'commanding heights', import of select industries and export promotion (Rao et al, 1999).

Foreign collaboration, including foreign financial and foreign technical collaborations, approvals entered in the above periods does reflect different phases of FDI policy regime in the past⁷ (Figure 2.3). During the period 1961-1970, percentage of foreign financial collaborations, which was 25 percent of a total number of 3171 foreign collaborations, came down to 14 percent during 1971-1980. Such collaborations again registered an increase during the period 1981-1990, comprising 24 percent of foreign financial collaborations of a total number of 7435 foreign collaborations. During the initial post reform period 1991-1998, percentage of financial collaborations, containing FDI moved up sharply to 59 percent and subsequently to 84 percent between 1999-2004. More than double the number of financial collaborations was approved during 1991-1998 than it was in the entire three decades (1961-1990).

⁷ Foreign collaborations in India are solicited in two different forms i.e., foreign technical collaborations and foreign financial collaborations. The later involves technology agreement either by way of lump sum payment or by paying royalty/fees for a stipulated period. As technical collaborations do not involve any equity agreement, these collaborations are not strictly considered as FDI by definition. Such collaborations are called as non-equity form of FDI. On the other hand, foreign financial collaborations involve equity participation and certain percentage of equity, e.g., 10 percent (IMF, BoP Manual, 2003) that gives management control of the business by foreign company, qualify as FDI.

Figure 2.3: Number of Foreign Collaboration Approvals in Different Periods



Note: FCs: Financial Collaborations and TCs : Technical Collaborations

Source: CMIE, BoP Statistics, July, 1996 issue and SIA, Newsletter Various Issues.

2.3.1 Phase-I (1948-1967): A Case of Cautious and Selective Attitude to FDI

In this phase, foreign investment policy was conditioned by two industrial policy resolutions (IPRs) of 1948 and 1956 and foreign exchange crisis of late fifties. During the period, imports-substitution strategy for industrialization in pursuance with 'commanding heights' of IPR 1956 was followed with a view to build local capabilities, especially in heavy industries segment and in machinery manufacturing industries. Technological base of the economy was at its initial stage during early part of this period. In order to promote technological development, policy was directed towards technology imports and foreign investments and technological collaborations were sought in high technology areas. Foreign investments in low technology industries were restricted to nurture

and develop local industries (Rao et al, 1999). Dual nature of the policy intention, during the period, was clear in a sense to build national technological capacity through foreign collaborations in high technology areas where it was a bare necessity and to discourage foreign collaborations in low technology areas to protect and nurture local industries. Limited technological base coupled with skills, inadequate entrepreneurs led to a receptive attitude towards FDI. FDI was sought on mutually advantageous terms, with a majority local ownership. Foreign investors assured of no restrictions on profits and dividends repatriations as well as accorded national treatment and compensation in case of acquisitions (Kumar, 1998). During 1857-58, India encountered a foreign exchange crisis. Further liberal attitude was also displayed towards FDI in projects involving foreign exchange components. This was the period when many TNCs serving Indian markets through exports started establishing their affiliates in India as manufacturing base. During the period, major TNCs were in the field of oil refining worldwide. A few TNCs in the business of oil refining in India were taken over by the State. Subsequently, formation of Oil and Natural Gas Corporation (ONGC) and Indian Oil Company (IOC) took place in 1955 and 1959 respectively (Martinussen, 1988).

2.3.2 Phase-II (1968-1979): A Case of Restrictive Attitude to FDI

After a brief period of openness and receptive policy attitude towards FDI, policy regime became further restrictive during the period 1968-1979. Earlier period was marked by a conscious attempt to create national industrial assets, build technological capabilities, skills, human resources and supremacy of the State under 'commanding heights' was accorded top priority. As a consequence, FDI was cautiously and selectively welcomed in the areas of high technology and high priorities, leaving a space for the flourishing of the domestic industries. This had

led to formation of local capabilities in the areas of machinery fabrication, process and product adaptations. Further, development of local engineering design capabilities, project management and handling had also led to considerable building up local capabilities. As a result, share of imported machinery and equipment as proportion of gross capital formation, which was around 69 percent in 1950, had come down to about 25 percent by 1968-69 (Kumar, 1998). On the other hand, outgo of foreign exchange on account remittances of profits, dividends, royalties and technical fees for servicing of foreign investments committed during the first phase substantially increased during end of the first phase. All these factors had reinforced adoption of a restrictive attitude towards FDI in the second phase so as to protect the created national industrial assets from the competition on the ground of infant industries' argument in one hand and also to tread on the path of self-reliance by way of cutting down imports and remittances on account of profits, dividends, royalties and technical fees on the other.

During the period, FDI was restricted on those coming without technical collaborations. Restrictions were also imposed on foreign companies seeking more than 40 percent of equity participation. Such proposals required to be approved by Reserve Bank of India (RBI). Government also listed the industries where foreign participation was not desirable on the ground of local capabilities. Payment of royalties and fees was also capped to certain limits. Restrictions were also extended with respect of renewal of foreign collaborations and guidelines to use Indian consultancy services. In 1969 a more precise policy was evolved. Industries were divided into three groups and foreign collaborations were entertained in two out of the three industrial groups, viz., (i) FDI with technical collaboration and (ii) only technical collaboration. As discussed above, this was

done to restrict foreign participation, especially FDI, in strategic industries but technological collaborations were entertained to build national capability.

The regulatory framework for FDI continued and further consolidated with the enactment of Foreign Exchange Regulation Act (FERA), 1973. With FERA, foreign companies were required to undergo compulsory registration under Indian corporate legislation up to a foreign equity holding of 40 percent. However, regulation of foreign exchange did not ease the constraint of foreign exchange. As a result, flexibility of FERA was extended to foreign companies engaged in tea plantations, exports oriented business and high technology and high priority areas. The FERA exemptions were given to the following categories of non-resident companies. First, companies were permitted to hold 74 percent of equity abroad if exports were of more than 60 percent of outputs. Second, permission for 51 percent of equity holding was allowed if 60 percent of the company's turnover was in core sector with 10 percent of export commitment. Third, 100 percent export oriented companies were allowed 100 percent equity holding. Nevertheless, there was no discrimination between domestic and foreign companies apart from FERA companies.

While regulatory framework under FERA was at least a partial success due to foreign exchange constraint, to some extent objective of equity dilution was fulfilled. As a consequence, number of foreign branches came down considerably from 500 in 1974 to 300 in 1980 (Martinussen, 1988).

With a view to promote exports, Government established Free Trade Zones (FTZs) at Kandla (Gujarat) and Santa-Cruz (Bombay) in 1965 and 1972

respectively, drawing successful experiences of similar FTZs available at the time in other Asian countries and Special Economic Zones (SEZs) in China. The Government liberally designed policy and given incentives towards promoting FDI in these zones.

Further in IPR 1973, more specific policy was evolved, detailing the number of industries where foreign companies could operate with or without FDI. Once again, the restrictions of FDI were made to sectors producing basic intermediate, capital goods and consumer goods. At the same time, the foreign equity limit was revised upward from 40 percent to 49 percent in high technology and priority sectors and foreign participation was limited to only Government joint ventures.

2.3.3 Phase-III (1980-1990): A Case of Initial Deregulation

In the second phase, intent of the FDI policy was to promote and protect the created national industrial assets and to further develop local technological capabilities. FDI was restricted to the areas of high priorities and high technology requirements, with Government joint ventures. The FERA, 1973, which brought the maximum restrictions on foreign companies, was found to be successful to a limited extent due to the foreign exchange constraint. Foreign exchange constraints led to several exceptions, which were granted with a view to build foreign exchange reserves. The objective of FERA could only bring dilution of foreign equity to some extent and simultaneously enhancing the local participation. Restrictions on new foreign investments as well as on the existing foreign companies did not augur well for India as expected. India's export competitiveness declined due to low technology and protected market. The third phase of policy, while recognizing above, brought in a partial liberalization in the

trade and investment policy with an objective of enhancing exports competitiveness, modernization and marketing of exports through TNCs.

During this period, a partial liberal attitude towards foreign investment came into being with the announcement of Industrial Policy, 1980 and 1982 and Technology Policy, 1983. The third phase was characterized by changes in the policy directions, such as, de-licensing some of the industrial rules and promotion of Indian manufacturing exports, emphasizing on modernization of industries through liberalized imports of capital goods and technology. During the period, the restrictive features of Monopolistic and Restrictive Trade Practices (MRTP) Act were also softened to some extent. The policy changes, specific to foreign investments include (i) setting up of four new Export Processing Zones (EPZs) for attracting foreign companies and (ii) relaxation of FERA for 100 percent export oriented units. Besides, 40 percent ceiling on foreign ownership was relaxed in some cases and also included relaxation of rules and procedures regarding payments of royalties and technical fees. This period also began with trade liberalization by tariff reduction and shifting of large number of items from import licensing to Open General Licensing (OGL).

All the measures adopted during the phase III were in fact enabled India to further move ahead with the process of liberalization, modernization and enhancing efficiency of the industrial sector in 1990s.

2.3.4 Phase-IV: Post Reform Period

Economic liberalization process, which was introduced under SAP with supports of IMF and World Bank, culminated into a series of economic reforms in July 1991. Along with a host of industrial policy reforms that came with the announcement of NIP 1991, policies concerning FDI marked a new dawn that significantly divide the FDI policies evolved during the entire period from post independent era till 1990 and the period beginning 1991 and thereafter. NIP 1991 recognized the role of FDI in the process of industrial development in India in terms of bringing greater competitiveness and efficiency and also modernization, technological upgradation, creation of a sound base for exports promotion and above all integrating India with rest of world. The major highlights of policy changes are as under.

1991

- ❑ Abolition of industrial licensing system except for 18 industries under strategic and environmental concerns.
- ❑ Ceiling of 40 percent foreign equity under FERA done away with.
- ❑ Removal of registration under MRTP act.
- ❑ Introduction of the dual approval systems for FDI proposals viz., (i) through an automatic approval channel for FDI in 35 priority sectors by Reserve Bank of India (RBI) up to an equity participation of 51 percent and (ii) through formal Government of India channel via. Foreign Investment Promotion Board (FIPB)/Secretariat for Industrial Assistance (SIA).
- ❑ Existing companies were allowed to hike their foreign equity up to 51 percent in priority sector.
- ❑ Liberalization of the use of foreign brands name.

- Abolition of Phased Manufacturing Programme (PMP) for high local content.
- Dilution of 'dividend balancing conditions' and its related exports obligation except in case of 22 consumer goods industries.
- Removal of restrictions of FDI in low technology sectors.
- Automatic permission for technology agreement in high priority industries.
- Removal of condition for FDI with necessary technology agreements.
- Liberalization of technology imports.
- Permission for Non-Resident Indians (NRIs) and Overseas Corporate Bodies (OCBs) under automatic route with repatriation of capital income to invest up to 100 percent equity in high priority industries.
- India became a signatory to the Convention of the Multilateral Investment Guarantee Agency (MIGA) for protection of foreign investments.

All these measures adopted during 1991 marked a major departure of FDI policies adopted before 1991 and ushered a new era for FDI in India. These initial measures underwent revision and further liberalization in the contents of the above measures was introduced subsequently after 1991 to project India as one of the top hosts for FDI. Followings are the subsequent reform measures that came into being specifically in 1997, 2000 and post-2000.

1997

- Industrial licensing requirement in industries of strategic and environmental concerns pruned further.
- In January 1997, another 13 industries were brought under 51 percent foreign equity participation and 9 other high priority industries were earmarked in

metallurgical and infrastructure sectors where equity participation has been raised up to 74 percent and 100 percent for NRIs in select industries. A total 111 sectors were put under automatic approval with equity cap of up to 100/74/51/50 percent.

- Further, procedural simplification was brought in the automatic FDI approval channel. Earlier practice of obtaining prior approval was dispensed with. Companies were allowed to inform RBI after shares were issued to non-resident companies.
- Relocation of FIPB from Prime Minister's office to Secretariat for Industrial Approval, Ministry of Commerce and Industry, Government of India.

2000 and after

- Lists of industrial licensing in industries of strategic, environmental and locational factors further curtailed to a minimum number.
- Opening up new sectors, such as, mining, banking, insurance, telecommunications, construction and management of ports, harbours, roads and highways and defence equipment subject to equity caps. A detail list of sectoral guidelines (as on March 2005) indicating percentage of foreign equity cap is given in Annexure 2.1.
- Sectors earmarked for automatic approval of FDI expanded to include almost all sectors and equity cap raised to 100 percent (Annexure 2.2), barring a few negative list, such as, industries requiring industrial licensing in strategic, environmental and locational grounds. Lists of industries requiring compulsory licensing and terms and conditions requiring case-by-case approval from FIPB are given in Annexure 2.3.
- 100 percent FDI is permitted in most manufacturing sectors with automatic approval, such as, textiles, paper, basic chemicals, drugs and pharmaceuticals,

rubber, plastic, non-metallic mineral products, metal products, ship/boat building, machinery and equipment and automobiles (Annexure 2.4). FDI limit of 24 percent continues for Small Scale Industries (SSIs) and 26 percent for defence equipment.

- Dividend balancing conditions and its related exports obligation on foreign investors were completely withdrawn in case of 22 consumer goods industries.
- Scrapping of the Press Note 18, requiring no-objection certificate from the existing joint venture partners⁸.

Progressive and phased liberalization measures adopted for promoting FDI during the post-reform period created a much-desired environment for business growth and FDI inflows in India. The most important among all are (i) abolition of industrial licensing requirement for business set up except for few industries of strategic and environmental and locational concerns, (ii) gradual hiking up FDI ceiling in a phased manner (Annexure 2.5) (iii) increasing number of sectors under automatic route and keeping few sectors, such as, industries requiring compulsory licensing, manufacturing items reserved for SSIs and investment locations attracting locational restrictions, and (iv) liberalization of foreign exchange regulations by way of simplification of procedures for making inward and outward remittances. These apart, there were also several simplifications of procedures as part of investment facilitations, such as, electronic filing of applications, online chat facility with the applicants, online status on registration/

⁸ In December 14, 1998, Govt. of India issued Press Note 18, a set of rules applicable to FDI under automatic channel. It made mandatory for a foreign partner in a joint venture firm to obtain 'no objection certificate' from the existing Indian partner to float a wholly owned subsidiary in the same or allied fields. Many foreign firms were facing problems to start a wholly owned subsidiary even though the sector subsequently came under 100 percent automatic FDI channel.

disposal of applications and dedicated e-mail facility for investment related queries to facilitate a hassle free FDI promotion in the country.

Apart from the above policy measures for attracting FDI, the Central Government and most of the State Governments offer various incentives to attract FDI in most desired sectors and also for directing investments to underdeveloped regions. Incentives, like 100 percent profit deduction are available for infrastructure, 100 percent tax deduction for exports and undertakings in Special Economic Zones (SEZs) and various capital subsidy and fiscal incentives are offered for encouraging FDI in underdeveloped northeastern region by the Central Government. Several State Governments' incentives are also available for facilitating FDI projects, like single window approval system for setting up industrial units, making exemption of fee/duty for electricity, registration and stamp, giving rebate on land cost, reserving plots for NRIs and Export Oriented Units (EOUs), offering tax concessions and octroi refunds and interest rate and fixed capital subsidy (Annexure 2.6).

These policy changes intended for making India an investors' friendly destination for FDI has undergone more than a decade's experience. The following section analyzes the trends and patterns of FDI inflows in the context of these policies change. This shall provide with factual bases for developing an empirical framework and for undertaking an empirical study in India's experience with FDI.

2.4 THE TRENDS AND PATTERNS OF FDI INFLOWS: Post Reform Period

Adoption of an 'open door' policy towards FDI under NIP in 1991 and subsequent FDI policy liberalization ushered a new phase for India as a FDI attractive destination in the world. The major trends in the inflows of FDI into India are analyzed below.

2.4.1 Trends in Non-Debt Creating External Capital Inflows

Post 1991 has brought in much desired changes in the composition of external capital inflows to India. The debt component of external capital inflows, which used to comprise a major share during pre-1991 period, gradually featured a decline after 1991⁹. Debt component of the external capital inflows, which was 83.3 percent in 1990-91, came down to 52.4 percent in 1997-98 and further to a negative 10.6 percent in 2002-03, (RBI, Report on Currency and Finance, 2004). In the process, non-debt creating external capital inflows emerged as an important external financing of development and growth¹⁰. The share of non-debt creating external capital inflows in total external capital inflows, which was at 16.7 percent in 1990-91, rose phenomenally to 54.8 percent in 1997-98 and further to 77.1 percent in 2001-02. In 2002-03, it declined to 46.6 percent, due to lower levels of FDI and portfolio investments. More importantly, percentage share of FDI in non-debt capital flows consistently increased from 1.4 percent in 1990-91 to 36.2 percent in 1997-98. It rose further to reach a peak of 58 percent in 2001-02 and

⁹ Debt components of external capital flows comprise external assistance, external commercial borrowings, short-term credits, NRI deposits and rupee debt service. Debt, as it suggests, involves servicing including interest burden on the country. The burden is more when return of the assets created out of it is not enough to service the interest part of it.

came down to 38.5 percent in 2002-03 (RBI, Report on Currency and Finance, 2004). The progressive rise in the share of non-debt component of external capital inflows is certainly in response to the policy reforms pursued during the post reform India.

2.4.2 Trends in FDI Inflows by Various Channels

The policy change in the post reform period brought a major alteration in terms of actual inflows of FDI and through various channels. The total FDI inflows in absolute term has gone up from US \$130 million in 1991-92 to a staggering US \$3557 million in 1997-98, recording an annual average growth of 79 percent during the period 1991-98 (Table 2.6).

During initial years of the reforms period, there used to be a large gap between FDI pledged during approval and actual FDI inflows realized in the country. That is percentage share of FDI inflows in FDI approvals, which averaged at 28.25 percent during the period 1991-92 to 1997-98, improved significantly to 94.35 percent during the second period from 1998-99 to 2002-03 (Table 2.7). The large difference between approvals and inflows during the early period 1991-92 to 1997-98 may be due to phased liberalization process of FDI adopted during 1991 and subsequently during 1997 and 2000. During the early period, many sectors were kept outside the FDI and sectors available for FDI were tagged with FDI limit and other terms and conditions in the form of special case-by-case approval if the FDI proposal was outside the automatic channel. Secondly during initial period, investors were cautious about continuity of the policy changes in future.

¹⁰ The non-debt creating external capital inflows comprise two components, namely, FDI and foreign portfolio investment. The FDI component of it is more important because of its long-term nature and non-speculative in character, which helps in growth and development of the country.

These factors would have led to the large difference in FDI inflows and approvals, which subsequently narrowed down during the second period 1998-99 and 2002-03.

Table 2.6: FDI Inflows by Various Channels (1991-92 to 1997-98)

(In Million US \$)

	1991-92	1992-93	1993-94	1994-95	1995-96	1996-97	1997-98	Total
Total Inflows	130	320	590	1310	2144	2821	3557	10872
Total Equity Capital	130	320	590	1310	2144	2821	3557	10872
Government (SIA/FIPB)	70	220	280	700	1249	1922	2754	7195
% Share in Total	53.85	68.75	47.46	53.44	58.26	68.13	77.42	66.18
RBI	N.A	40	90	170	169	135	202	806
% Share in Total	N.A	12.50	15.25	12.98	7.88	4.79	5.68	7.41
NRI	60	60	220	440	715	639	241	2375
% Share in Total	46.15	18.75	37.29	33.59	33.35	22.65	6.78	21.85
Acquisition of shares @	N.A	N.A	N.A	N.A	11	125	360	496
Equity capital of unincorporated Bodies	N.A	N.A	N.A	N.A	N.A	N.A	N.A	N.A
Re-invested Earnings \$	N.A	N.A	N.A	N.A	N.A	N.A	N.A	N.A
Other Capital \$\$	N.A	N.A	N.A	N.A	N.A	N.A	N.A	N.A

Notes:

(a) N.A: Refers to not available

(b) @: Relates to acquisition of shares of Indian companies by non-residents under Section 5 of FEMA, 1999. Data on such acquisitions have been included since January 1996

Source: Reserve Bank of India, Annual Report, Various Issues.

Table 2.7: Trends in FDI approvals and inflows

Year	(In Million US \$)		
	Approvals	Inflows	Share of Inflows in Approvals (%)
1991-92#	527	165	31.31
1992-93	1976	393	19.89
1993-94	2428	654	26.94
1994-95	3178	1374	43.23
1995-96	11439	2141	18.72
1996-97	11484	2770	24.12
1997-98	10984	3682	33.52
1998-99	7532	3083	40.93
1999-00	4266	2439	57.17
2000-01	5754	2908	50.54
2001-02	3160	4222	133.61
2002-03	1654	3134	189.48

Note: (a) # Refers to August-March

(b) There is difference in aggregate FDI inflows data reported by RBI and SIA, Ministry of Commerce and Industry, Govt. of India. The difference may be due to errors and omissions.

Source: Economic Survey, 2004-05, Govt. of India, New Delhi

Dual channels of FDI approvals, viz., RBI automatic and Government (FIPB/SIA) channels were opened to attract FDI in to India. While RBI automatic route was opened for FDI in most preferred/high priority sectors with an equity cap, Government channel was opened to deal with proposals coming outside the purview of automatic channel. Third channel was through NRI channel basically entertained through RBI. During the post-policy period (1991-92 to 1997-98), out of total FDI inflows of US \$10872 million, FDI inflows through RBI automatic channel were quite meager at US \$ 806 million, comprising only 7.41 percent. On the other hand, FDI inflows through FIPB/SIA were quite high at US \$7195 million, comprising 66.18 percent of the total FDI inflows during the period. FDI inflows through NRI route were US \$2375 million, with a percentage share of 21.85 percent of the total inflows during period (Table 2.6). FDI through

acquisitions of shares was reported from January 1996¹¹. Such FDI inflows rose from US \$11 million in 1995-96 to US \$360 million in 1997-98, aggregating to US \$496 million between 1995-96 and 1997-98. Since the introduction of liberalization of FDI policies, many non-resident companies those were already having limited equity holding in Indian companies, subsequently hiked their equity stakes through acquisitions of shares under automatic approval (Goyal, 1997).

The lower percentage of FDI inflows through RBI automatic channel, although it was opened with a purpose of attracting FDI in high/preferred sectors compared to Government channel is remarkable. The reasons are many but the most important one is most of sectors, at the initial period 1991-1997, were kept out of the automatic route with foreign equity capped at 51 percent, which might have led TNCs to come through FIPB/SIA route those seeking in excess of the equity cap or in sectors coming outside the RBI automatic route.

Further liberalization in the FDI policy was brought in during 1997. The second period from 1998-99 to 2002-03 is considered for analysis. During this five-year period a total of US \$19437 million worth of FDI came to India, a 78.78 percent higher than compared to US \$10872 million during the pervious period 1991-92 to 1997-98 (Table 2.8). FDI coverage from 2000-01 was broaden to include equity capital of unincorporated bodies, re-invested earnings and other capital to be in line with international practices, rendering data incomparability in the period 2000-01 to 2002-03 and the previous period. However, excluding these newly

¹¹ Acquisitions of shares of Indian companies by non-residents under Section 5 of FEMA, 1999 as a part of FDI was made available since January 1996. There were a number of companies operating in India whose stake of foreign holdings were increased through this route after liberalization of FDI policies.

introduced heads, FDI inflows during the second period amounted to US \$13434 million, indicating a 23.57 percent higher than the earlier period. Few noticeable changes occurred in the compositions of FDI inflows during this period, such as, FDI inflows through RBI started showing increasing share from the beginning of the period 1998-99 and consequent decline in the share of FDI inflows through FIPB/SIA and there was also an appreciable increase in the FDI accounted for by one of newly introduced headings, namely, re-invested earnings and FDI under acquisition of shares. During the second period, FDI inflows through RBI automatic channel increased to US \$2310 million, forming 11.88 percent of the total inflows compared to 7.41 percent during earlier period. Consequently, FDI inflows through FIPB/SIA, during second period, stood a little higher at US \$7827 million, comprising 40.27 percent of the total inflows against a share of 66.18 percent in the previous period. These changes in the compositions of FDI inflows could be related to changes in the FDI policies that followed during 1997 and thereafter, which include enhanced coverage of sectors under automatic route and subsequent hike of sectoral FDI cap. However, increase of FDI inflows through automatic route is not high in commensurate with the enhanced coverage of sectors and hike in sectoral FDI cap.

Table 2.8: FDI Inflows by Various Channels (1998-99 to 2002-03)

(In Million US \$)

	1998-99	1999-00	2000-01	2001-02	2002-03	Total
Total Inflows	2462	2155	4029	6131	4660	19437
Total Equity Capital	2462	2155	2400	4095	2700	13812
Government (SIA/FIPB)	1821	1410	1456	2221	919	7827
% Share in Total	73.96	65.43	36.14	36.23	19.72	40.27
RBI	179	171	454	767	739	2310
% Share in Total	7.27	7.94	11.27	12.51	15.86	11.88
NRI	62	84	67	35	Neg.	248
% Share in Total	2.52	3.90	1.66	0.57	--	1.28
Acquisition of shares @	400	490	362	881	916	3049
% Share in Total	16.25	22.74	8.98	14.37	19.66	15.69
Equity capital of unincorporated Bodies	N.A	N.A	61	191	126	378
% Share in Total	N.A	N.A	1.51	3.12	2.70	1.94
Re-invested Earnings \$	N.A	N.A	1350	1646	1498	4494
% Share in Total	N.A	N.A	33.51	26.85	32.15	23.12
Other Capital \$\$	N.A	N.A	279	390	462	1131
% Share in Total	N.A	N.A	6.92	6.36	9.91	5.82

Notes:

N.A refers to not available and Neg refers to negligible amount.

@ : Relates to acquisition of shares of Indian companies by non-residents under Section 5 of FEMA, 1999. Data on such acquisitions have been included since January 1996

\$: Data for 2002-03 are estimated as average of previous two years.

\$\$: Data pertain to inter company debt transactions of FDI entities.

SIA/FIPB : Secretariat of Industrial Assistance/Foreign Investment Promotion Board.

Data on FDI have been revised since 2000-01 with expanded coverage to approach international best practices. FDI data for previous years would not be comparable with those figures.

Source: Reserve Bank of India, Annual Report, Various Issues.

2.4.3 Trends in FDI Inflows by Various Sectors

Liberalization of FDI policy is also responsible for a changing sectoral distribution of FDI inflows in India. Cumulative FDI stock and its percentage shares in various sectors and sub-sectors were compared at three different points of time, i.e., 1979-80, 1989-90 and 1996-97, basically indicating the sectoral FDI status at pre-policy period and post-policy period¹². There was no perceptible change in the compositions of FDI stock during the periods, viz., 1979-80 and 1989-90 (Table 2.9). The changing compositions of FDI stock were noticeable in 1996-97 as compared with 1989-90 in respect of two major sectors, namely, manufacturing and services.

Manufacturing sector, which was dominating in the aggregate FDI stock, comprising about 87 percent and 85 percent during pre policy periods of 1979-80 and 1989-90 respectively, came down to 48 percent in 1996-97. On the other hand, services sector whose percentage share in FDI stock, which was around 3 percent in pre-reform period, went up to 15 percent in 1996-97, in the post policy period. Within the manufacturing sector, though all the major industries experienced a decline in the FDI stock, the sharp decline was observed in respect of two industries, namely, machinery & machine tools and chemicals and allied products, whose percentage shares declined from 13.09 percent and 28.43 percent respectively in 1989-90 to 5.29 percent and 8.91 percent in 1996-97. These changing sectoral compositions have been mainly in response to the changing sectoral compositions occurring at the global FDI level, wherein the compositional shift has been taking place from manufacturing sector to services. Nevertheless, with the change in relative compositions of FDI, the place of manufacturing sector as a major FDI attraction has not been diminished.

**Table 2.9: Sector wise Distribution of FDI inward Stock:
In Pre and Post Reform Period**

(In Rs. Million)

Industry Group	1980		1990		1997	
	Value	Share (%)	Value	Share (%)	Value	Share (%)
I. Plantations	385	4.13	2560	9.46	4310	1.18
II. Mining	78	0.84	80	0.3	410	0.11
III. Petroleum	368	3.94	30	0.11	3330	0.91
IV. Manufacturing	8116	86.97	22980	84.95	175230	48
1. Food & Beverages	391	4.19	1620	5.99	24310	6.66
2. Textile Products	320	3.43	920	3.4	10390	2.85
3. Transport Equipment	515	5.52	2820	10.43	24570	6.73
4. Machinery and Machine Tools	710	7.61	3540	13.09	19310	5.29
5. Metals and Metal Products	1187	12.72	1410	5.21	7600	2.08
6. Electrical Goods and Machinery	975	10.45	2950	10.91	29400	8.31
7. Chemicals and Allied Products	3018	32.34	7690	28.43	32530	8.91
8. Others	1000	10.72	2030	7.5	27120	7.43
V. Services	320	3.43	890	3.29	54650	14.97
VI. Others	65	0.7	510	1.89	127170	34.83
Total	9332	100	27050	100	365100	100

Note: All figures refer to the financial year ending March

Source: Nagesh Kumar (2005)

¹² FDI stock figure are not regularly available. For instance, FDI stock figure for 1997 is made available in 2000 by RBI.

During the period 1992-93 to 1997-98, FDI inflows to manufacturing sectors aggregated to US \$ 4864 million, accounting for a percentage share of 60.85 in total (Table 2.10). FDI inflows to services (excluding finance) aggregated to US \$ 551 million with a percentage share of 6.89. Various manufacturing industries' shares during the period comprise 11.86 percent for chemical and allied products, 3.45 percent for computers, 2.48 percent for engineering, 13.45 percent for electronics and electrical equipments, 7.11 percent for food and dairy products and 2.50 percent for pharmaceuticals industries. A compositional shift in FDI inflows was observed during the second period 1998-99 to 2002-03, wherein manufacturing share in total FDI inflows registered a decline to 52.99 percent compared to 60.85 percent in the initial period (1992-93 to 1997-98), with sharp decrease in percentage shares registered in chemical and allied products and engineering (Table 2.11). The decline in FDI inflows to manufacturing sector during the second period was due to the emergence of services sector as an important recipient of FDI. Percentage share of FDI inflows to services sector (excluding finance), during the second period, accounted for 23.15 percent compared to a 6.89 percent during the initial period 1992-93 to 1997-98. The emergence of FDI inflows to services sector and others, which included infrastructure, such as, power in second period had been due to further liberal FDI policies adopted during the said period. Though percentage share of FDI inflows to manufacturing declined over time, yet it continued to occupy a major recipient of FDI inflows during post policy period.

Table 2.10: Sector wise Distribution of FDI Inflows (1992-93 to 1997-98)

(In Million US \$)

Sectors	1992-93	1993-94	1994-95	1995-96	1996-97	1997-98	Total	Share (%)
Chemical and Allied Products	47	72	141	127	304	257	948	11.86
Computers	8	8	10	52	59	139	276	3.45
Engineering	70	33	132	252	730	580	1797	22.48
Electronics and Electrical Equipment	33	57	56	130	154	645	1075	13.45
Finance	4	42	98	270	217	148	779	9.74
Food and Dairy Products	28	44	61	85	238	112	568	7.11
Pharmaceuticals	3	50	10	55	48	34	200	2.50
Services	2	20	93	100	15	321	551	6.89
Others	85	79	276	348	292	720	1800	22.52
Total	280	405	877	1419	2057	2956	7994	100.00

Note: Includes shares under Section 5 of FEMA, 1999 from 1995-96.

Source: Annual Report, Reserve Bank of India, various issues.

Table 2.11: Sector wise Distribution of FDI Inflows (1998-99 to 2002-03)

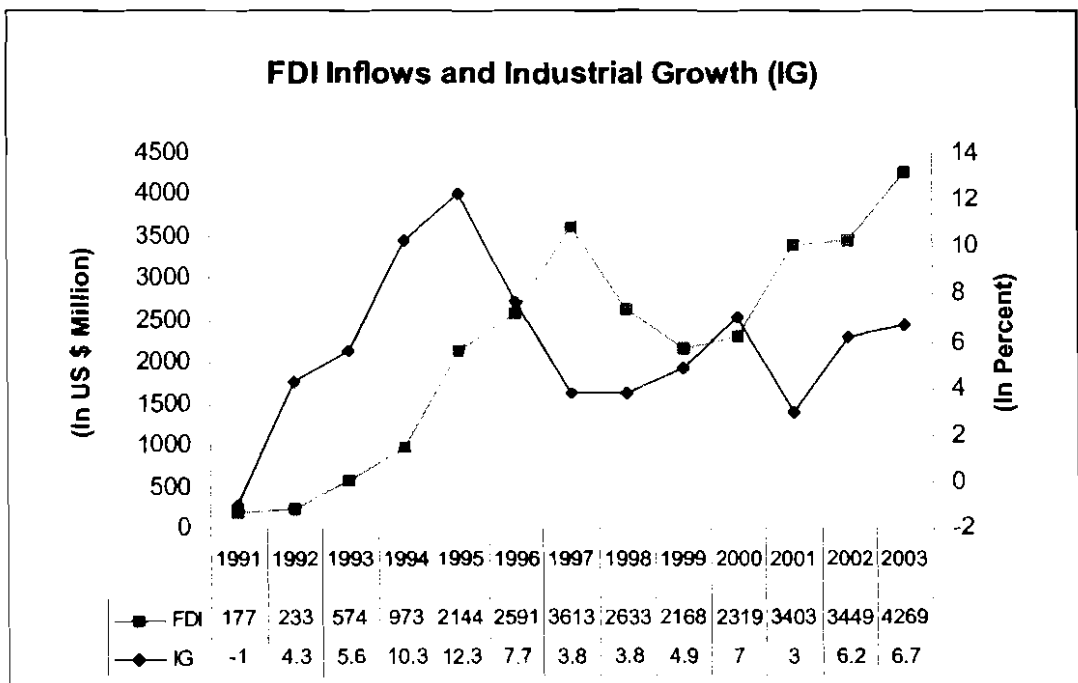
(In Million US \$)

Sectors	1998-99	1999-00	2000-01	2001-02	2002-03	Total	Share (%)
Chemical and Allied Products	376	120	137	67	53	753	7.43
Computers	106	99	306	368	297	1176	11.60
Engineering	428	326	273	231	262	1520	14.99
Electronics and Electrical Equipment	228	172	213	659	95	1367	13.49
Finance	185	20	40	22	54	321	3.17
Food and Dairy Products	19	121	75	49	35	299	2.95
Pharmaceuticals	28	54	62	69	44	257	2.54
Services	368	116	226	1128	509	2347	23.15
Others	262	553	578	395	309	2097	20.69
Total	2000	1581	1910	2988	1658	10137	100.00

Source: Annual Report, Reserve Bank of India, various issues.

Trends in annual FDI inflows have also responded fairly well to the annual growth in industrial sector of India (Figure 2.4). Annual growth in industrial performance as measured in terms of the percent variation in the Index for Industrial Production (IIP). It is evident that industrial growth of IIP and annual inward FDI flows have moved in tandem, which indicates, *inter alia*, a high domestic industrial growth a facilitator for high FDI inflows. This indeed reflects, in addition to policy, the role of economic fundamentals in attracting higher FDI inflows.

Figure 2.4: FDI Inflows and Industrial Growth



Source: Nagesh Kumar (2005).

2.4.4 Trends in FDI Inflows by Country of Origin

Changing composition of FDI stock as well as inflows by country of origin is another feature observed during the post policy period. Compositions of inward FDI stock by country of origin was observed to have undergone a change between two points of time, namely, 1992 and 1997 (Table 2.12). In 1992, share of the inward FDI stock of European countries' in total inward FDI stock was 64.63 percent with a major share coming from the UK (40.23%) and Germany (12.40%). The share of the US accounted for another 18.57 percent. During 1997, these compositions underwent a change with the decline in the share of the inward FDI stock of European countries' in total inward FDI stock to 24.85 percent. The shares of the UK and Germany also declined to 11.99 percent and 5.69 percent in 1997 as compared to their shares in 1992. Mauritius, a small island country's share, which was nearly a non-existent in 1992, increased to 17.93 percent in 1997.

Table 2.12: Inward FDI Stock by Country of Origin

(Rs. in Million)

Major Source Countries	1992		1997	
	Value	Share (%)	Value	Share (%)
Mauritius	N.A	N.A	6546	17.93
USA	713	18.57	5019	13.75
UK	1545	40.23	4379	11.99
Germany	476	12.4	2078	5.69
Japan	213	5.55	1958	5.36
Netherlands	164	4.27	1175	3.22
Switzerland	185	4.82	785	2.15
Singapore	N.A	N.A	449	1.23
Canada	108	2.81	367	1.01
Hong Kong	N.A	N.A	346	0.95
France	19	0.49	329	0.9
Sweden	93	2.42	328	0.9
Belgium	N.A	N.A	257	0.7
Others	324	8.44	12494	34.21
Total	3840	100	36510	100

Notes: (a) N.A refers to not available

(b) All figures are as at the financial year ending March.

Source: Nagesh Kumar (2005)

During the initial period, 1992-93 to 1997-98, out of aggregate FDI inflows of US \$ 7991 million (Table 2.13), 79.78 percent of FDI inflows were from top ten countries, such as, Mauritius (30.66%), the USA (18.12%), the UK (4.68%), Germany (6.36%), Netherlands (5.58%), Japan (6.01%), France (0.41%), Singapore (2.18%), Switzerland (1.05%) and South Korea (4.69%). Percentage share of FDI inflows from European countries accounted for 18.08 percent, leaving a major share of FDI inflows from Mauritius and the USA. Emergence of Mauritius as a major source of FDI inflows has nothing to do with the island's

status as an FDI originator's country, rather its status of 'tax heaven'. Double taxation avoidance agreement that India entered with Mauritius had become an additional benefit in the form of reducing tax liability for TNCs from the USA and the UK to route their investments through Mauritius to India. On the other hand, India had the maximum FDI from two major countries, namely, the USA and the UK. During the second period, 1998-99 to 2002-03, percentage shares of FDI inflows from top ten countries underwent a compositional shift in favour of Mauritius and the USA comprising 42.72 percent and 17.36 percent of the total inflows of FDI worth US \$10137 million (Table 2.14), with shares of the UK (3.26%), Germany (4.29%), Netherlands (3.68%), Japan (7.32%), France (2.31%), Singapore (1.13%), Switzerland (0.48%) and South Korea (1.33%). Percentage share of FDI inflows from European countries declined to 14.02 percent of total inflows during the second period compared to 18.08 percent in the initial policy period of 1992-93 to 1997-98, while the share of FDI inflows from Japan went up from 6.01 percent in the initial period to 7.32 percent in the second period.

Table 2.13: FDI Inflows by Country of Origin (1992-93 to 1997-98)

(In Million US \$)

Major Source Countries	1992-93	1993-94	1994-95	1995-96	1996-97	1997-98	Total	Share (%)
Mauritius	N.A	N.A	197	507	846	900	2450	30.66
USA	22	99	203	195	242	687	1448	18.12
UK	7	98	144	71	54	N.A	374	4.68
Germany	21	35	35	100	166	151	508	6.36
Netherlands	21	47	45	50	124	159	446	5.58
Japan	26	37	95	61	97	164	480	6.01
France	9	10	14	N.A	N.A	N.A	33	0.41
Singapore	3	10	25	60	76	N.A	174	2.18
Switzerland	35	23	26	N.A	N.A	N.A	84	1.05
South Korea	N.A	N.A	12	24	6	333	375	4.69
Others	136	45	76	351	446	562	1616	20.22
Total	280	403	877	1418	2057	2956	7991	100.00

Note: N.A refers to not available

Source: Annual Report, Reserve Bank of India, various issues.

Table 2.14: FDI Inflows by Country of Origin (1998-99 to 2002-03)

(In Million US \$)

Major Source Countries	1998-99	1999-00	2000-01	2001-02	2002-03	Total	Share (%)
Mauritius	590	501	843	1863	534	4331	42.72
USA	453	355	320	364	268	1760	17.36
UK	N.A	N.A	61	45	224	330	3.26
Germany	114	31	113	74	103	435	4.29
Netherlands	53	82	76	68	94	373	3.68
Japan	235	142	156	143	66	742	7.32
France	N.A	N.A	93	88	53	234	2.31
Singapore	N.A	N.A	22	54	39	115	1.13
Switzerland	N.A	N.A	8	6	35	49	0.48
South Korea	85	8	24	3	15	135	1.33
Others	470	462	194	280	227	1633	16.11
Total	2000	1581	1910	2988	1658	10137	100.00

Note: N.A refers to not available

Source: Annual Report, Reserve Bank of India, various issues.

2.4.5 Investors Perceptions about India's FDI Policy Environment

Perceptions of investors about India as an important host destination have also been changed to a greater degree in recent times. India and China are aggressively challenging the United States as the world's most favored destination for FDI, according to the latest FDI Confidence Index, an annual survey of the world's largest 1000 companies conducted by A.T. Kearney (2003)¹³. India's position considerably improved from sixth to third most likely FDI location globally, the country's highest ranking ever after the USA. The latest survey report of Federation of Indian Chambers of Commerce and Industry (FICCI), 2004, revealed an improvement in the perception of investors towards India's capacity as a major FDI host in the near medium term. Some of the sectors that look promising in terms of FDI inflows are identified as IT and related services, chemical & chemical products, rubber & plastic products, electrical machinery & apparatus and services sector.

2.4.6 Beyond FDI Policy Environment

FDI policy regime has never been so conducive as it stands recently, fairly well comparable, even better, with other competing countries in developing world and specifically amongst Asian countries, including China. Despite the improvement in policy, FDI inflows in India are quite low. There are certain other factors, which acting as FDI repellent for India. The factors daunting the general investment climate that include various rules, regulations and moreover lack in clear interpretations. Most importantly, provision of world-class infrastructure and amendments to labour, land and rent controlling laws are needed for generating a conducive investment climate not only for foreign investors but for

¹³ Full report is available on http://www.atkearney.com/shared_res/pdf/FDICIOct_2004_S.pdf

domestic investors also. In this context, study by Dollar (2003) brought into light several other determinants of FDI inflows, which explain why do some countries attract more FDI than others. The positive relationship between investment climate indicators and international integration comes out to be significant determinants. A recent report, 'Doing Business in 2005' by World Bank has also pinpointed some of the India's investment climate indicators *vis-à-vis* other countries (Annexure 2.7).

Government has also taken several recent FDI facilitation initiatives to improve FDI inflows. Activation of the Foreign Investment Implementation Authority (FIIA) has been widely welcomed as a problem-solving platform for FDI related problems. A 'High-Powered Committee' has also been constituted by the Planning Commission, especially to look into and identify and dismantle the barriers associated with investments, including FDI. The Government had also set up a Steering Committee on FDI, which touched upon several incentive schemes to improve FDI inflows in India, with some of them already implemented (Annexure 2.8). Announcement of establishing several Special Economic Zones (SEZs) recently by Government of India will also provide opportunities for TNCs to use India as a global exporting platform.

2.5 SUMMARY

Global regional FDI flows, as a non-debt instrument of economic growth and development, reached ascendancy during last two decades. The share of FDI flows to developing countries as a percentage of total flows, gained increasing importance during 1990s. This is indicated from its increasing share as percentage to GFCF and the share of FDI stock in GDP. In the developing

countries, Asia and Pacific countries remained major FDI attraction, with East Asian countries and more particularly China becoming prime FDI locations. The relative FDI attractiveness of these countries is also witnessed in the improved rankings in terms of FDI performance and potential indices.

Historically India's policy towards FDI remained extremely cautious and selective in nature till the initiation of economic reforms in 1991. Major change in FDI policy in India happened with the introduction of NIP in 1991 and subsequent changes brought in thereafter with greater degree of liberalization.

The FDI policy reforms during 1990s have brought certain favourable alterations in the trends, patterns and compositions of FDI stock and inflows in India. India's capacity as a host nation in attracting FDI has been enhanced during the post reforms period though the quantum of FDI inflows relative to its size has been comparably low against other competing developing countries in general and some of the Asian countries like China in particular. The policy liberalization has not been so effective in increasing the larger FDI inflows to India either in the initial period of liberalization (1991-92 to 1997-98) or in the subsequent period with greater degree of liberalization contents adopted between 1998-99 and 2002-03. One of the main reasons for these low FDI inflows has been related to the investment climate and business felicitation, which are comparably at lower level.

As manufacturing sector of India has remained an important FDI absorbing sector of the economy during the post policy period, its impact on manufacturing growth through productivity augmentation as well as its spillovers on domestic manufacturing sector, forms the basis of the research analysis in the subsequent chapters of the thesis.

