CHAPTER-I

INTRODUCTION

An Overview of Foreign Investment in Indian Economy (Pre-Independence Era)

Foreign capital primarily dominated industrial and financial fields in India till the mid-1940s. The foreign trade network, as also part of the internal trade that fed into exports, was controlled by foreign capital. British companies dominated coal mining, jute industry, shipping, banking, insurance, and tea and coffee plantations. Moreover, through their managing agencies, British corporations controlled many of the Indian-owned companies. After 1920, the British giant companies – Unilever, Imperial Chemical Industries – were joined by several American multinationals, among them General Motors.

The large presence of foreign companies before independence, however, did not contribute to the growth of income in the country. In fact, it may have been a cause of India's underdevelopment as foreign investment was concentrated in production and export of raw materials and foodstuffs. There was practically no transfer of capital to India and it was a net exporter of capital to the U.K[1]. There was no scope for transfer of technology as most of the investment was concentrated in low technology extractive industries[1a].

Against this background, it is no wonder that after independence in 1947, an important plank of India's development policy was to discourage inflows of foreign capital. Foreign shareholding in existing companies was also reduced drastically by forced or voluntary transfer of capital into Indian hands. By the beginning of the 1980s, the share of foreign direct investment in gross capital formation was among the lowest for India among all developing countries ie; only 0.2 percent as against the average of about 6 percent for developing countries as a group[2]. The highly restrictive policies towards foreign investment continued, without any significant change, until mid-1991[3].

Development Strategy (Post Independence Era, 1951-1990)

India's development strategy, like that of most other developing countries, has evolved over successive Plan periods, reflecting the growing strength of our economy, structural transformations taking place in the domestic economy and also developments in the world economy. In the early stages of development planning, government was viewed as the principal actor in development, exercising strict control over private investment, ensuring a dominant role for the public sector in all the important industries. Trade policy tended to be inward oriented focussing on industrial development through import substitution, which was encouraged through a tight control over imports and maintenance of high tariffs. The limitations of this strategy became evident by the end of the 1970s and early 1980s when it became clear that these policies reduced efficiency and competitiveness and growth was much lower than targetted. Growth achieved during this period was 3.7 per cent (1951-81) as compared to 5.6 per cent (1982-1992)[4]. While government was over-active in industry, it was under-active in many areas, especially relating to social development and this was reflected in a very slow pace of improvement in critical social indicators.

Some efforts were made to reform the system in the second half of the 1980s to address the shortcomings in our development strategy. However, it was not until 1991 that wide-ranging programs of economic reforms aimed at decontrolling and debureaucratising the economy was initiated. These reforms have been pursued by successive governments since 1991 and enjoy a broad base of support. They have yielded reasonably good results so far. There is no doubt that the Indian economy has responded well to the change in policy direction and the growth rate increased from 5.8% in the Seventh Plan (1985-90) to 6.8% in the Eighth Plan (1992-97)[5]. However, there are many dimensions in which performance has lagged behind expectations. Faster growth has not reduced poverty as much as it should have, nor has it created the number of high quality jobs we need to satisfy the aspirations of our increasingly educated youths. Growth has not been as regionally balanced as it should have been. The deficiencies in social development indicators have also continued and our low level of social development is today a major constraint on reaching a growth rate of 8 per cent, which should be our medium term target.

Shift in Development Strategy (Economic Reforms 1991)

The era of reforms began in the Indian economy in 1991. The reform process has two components. One is the stabilization of the macro economy aiming at controlling fiscal and balance of payments deficits and controlling inflation through the appropriate interest rate, exchange rate and, fiscal and monetary policies. The second component refers to structural adjustment, which aims at removing controls in domestic economy and opening up of the economy to international trade and investment. The former aims at reforms in the internal sector and the latter in the external sector. These measures are expected to increase efficiency in the economy. Both stabilization and structural adjustment are aimed at putting the Indian economy on a higher growth path.

The reforms in India were triggered by a crisis in the external sector, caused mainly by foreign exchange and balance of payments imbalance. Reforms were started with two main objectives namely, a) to absorb and neutralise the shock of 1990-91 external crises and b) to set the economy on a higher growth path. However, while introducing the reforms certain economic and social factors need careful studies. In the domestic sector one needs to carefully examine the real economic factors and the financial factors. With respect to the external sector reforms, there are certain important factors, which needs consideration. These are namely the growth in the imports and the exports, the financial economy, covering the net financial flows in the country and the role of exchange rate as an integrating mechanism, which reflects the final balance of payment situation of the country. In examining the social dimension, the two important aspects are poverty and unemployment. This involves the question relating to the economic growth with a human face. Therefore, the economic reforms are meaningless if it fails to bring in qualitative improvement in the living standard of the people living below the poverty line, or to reduce the income inequality or the regional inequality or fail to provide jobs to the unemployed people of the nation.

Globalization and Growing Inequality : Necessity for a Balanced Liberalization of Labour and Capital

There are basically two important factors of production, labour and capital. With the process of integration of international economies and globalisation, the movement of capital has become free to a very large extent. However, labour remains immovable due to stiff immigration laws restricting the movements of labour

beyond the national boundaries. On the one hand, there is concentration of wealth/ capital in the developed countries and on the other hand, there is heavy burden of huge population in the developing countries. International institutionalization of various agencies i.e. IMF, World Bank and WTO has been generally dealing with the free movement of trade (goods and services) and investment (capital). The term free movement of trade in the form of services is a misnomer and it means free movement of service sector, which basically means banking, insurance shipping etc. and does not mean free movement of labour. Article V of General Agreement on Trade in Services of WTO deals with Labour Markets Integration Agreements in a very indicating manner and does not contain any forcible and concrete roadmap.

The flow of capital from the rich countries to the poor countries, undoubtedly it helps the development process with new technology and managerial skills does not, however, fully resolve their problems of unemployment and poverty. The results are evident from published figures of international agencies, particularly United Nations. There has been an increase in the capital concentration amongst the rich nations and the level of poverty and unemployment has increased amongst the poor nations. The Human Development Report 1999 of the UNDP supports this fact. The studies on the new economic order in the new millennium may lead the human society towards a balanced economic growth with a better quality of human life.

Economic Reforms in the Context of Washington Consensus

Policy errors in the past led to severe debt burden on the developing countries coupled with the problem of oil crisis from time to time which created the problems for balance of payments and servicing of debts. Several Latin American and African countries overburdened with debts underwent debt-crisis in early 1980s. IMF provided special loans and prescribed economic reform programmes the latest being popularly known as Washington Consensus.

John Williamson (1990), while presenting a paper on Latin American Economy, in a seminar in November 1989, defined what he called the ' Washington consensus' in relation to the policy of conditionality attached to Latin American countries at the time of the debt crisis. The consensus essentially boiled down to "free markets and sound money." Developing countries in Asia and Central and Latin America

and post-socialism countries in transition opened their economies following this consensus. According to Hale David (1994), "During the 1990s more than 50 developing countries have established domestic capital markets in order to encourage the privatisation of public enterprises and to encourage foreign investment." The tenets of the Washington consensus also known as "neoliberalism" or the policy manifesto for the developing economies can be summarized as follows :

- Governments should exercise fiscal discipline, obviating the need for an inflation tax.
- Public expenditure priorities should be shifted from politically sensitive areas to neglected fields with high economic returns and the potential to improve income distribution.
- Tax reform should broaden the tax base and reduce marginal rates. Ways should be found to tax flight of capital.
- Financial markets should be partially liberalized.
- Import quotas should be replaced by tariffs.
- Barriers impeding the entry of foreign firms should be removed; foreign and domestic firms should compete on equal terms.
- State enterprises should be privatized.
- Governments should remove regulations that are not justified by such criteria as safety, environment protection, or prudential supervision of financial institutions.
- Property rights should be safeguarded. (Louis Emmerij, 1997)

Principally, the International Monetary Fund (IMF) and the World Bank, the twin Bretton Woods Institutions (BWIs), transmit these recommendations toward developing economies. The stabilization and adjustment measures in recent years have been tied together in a "Policy Framework Paper" or PFP, which is agreed between the visiting team of IMF officials and the government officials consisting of professional economists.

However, in a recent discussion on the topic "The Washington Consensus Revisited" John Williamson has set out a new agenda which give more emphasis on increase in savings by maintaining fiscal discipline, reorientation of public expenditure towards well-directed social expenditure including education etc. BWIs are yet to

correct its prescription to debt- ridden developing countries according to the new prescription.

Leftists have criticized the Washington Consensus, as the joint manifesto of the World Bank, IMF and USA for a long time in the past. However, recently it has been criticized by none other than Joseph Stiglitz, chief economist of the World Bank, in a recent WIDER lecture (1998) entitled "More Instruments and Broader Goals: Moving towards the Post-Washington Consensus", where he said, "Macro-economic stability, as conceived by the Washington Consensus, downplays the stabilization of output or unemployment. Minimising or avoiding major economic contractions should be one of the most important goals of policy. The social and economic costs of these downturns can be devastating[6]."

Economic Reforms and Foreign Investment :
Meaning and Scope of Foreign Direct Investments (FDI)

Foreign Investment has been narrowly defined as the act of acquiring assets outside one's home country. These assets may be financial, such as bonds, bank deposits and equity shares or they may be so called direct investment and involve the ownership of the means of production such as factories and land. Direct investment is considered to take place also if the ownership of equity shares provide control over the assets of the firm[7].

Foreign investment has broadly two categories- Foreign Direct Investment (FDI) and Foreign Portfolio Investment (FPI). FDI is generally in the form of long-term investment in plant and machinery with foreign technology using foreign brand name either as a joint venture with an entrepreneur of the host country or by setting up a subsidiary company. FDI is undertaken by Multinational Companies (MNC'S) also known as Transnational Corporations (TNC'S). FPI or the Foreign Portfolio Investment means investment in stocks or bonds of the existing companies of the host country, which are traded in their stock exchanges and are generally for short-term gains. Foreign Institutional Investors (FII's) of the nature of insurance companies and pension funds undertakes FPI.

World Investment Report 1999 defines, foreign direct investment (FDI) as an investment involving a long-term relationship and reflecting a lasting interest and control of a resident entity in one economy (foreign direct investor or parent enterprise) in an enterprise resident in an economy other than that of the foreign

direct investor (FDI enterprise or affiliate enterprise or foreign affiliate)[8]. FDI implies that the investor exerts a significant degree of influence on the management of the enterprise resident in the other economy. Such investment involves both the initial transaction between the two entities and all subsequent transactions between them and among foreign affiliates, both incorporated and unincorporated. Individuals as well as business entities may undertake FDI.

World Investment Report 2000 has made a further classification of FDI in terms of (a) Brown-field FDI and (b) Green-field FDI. The former denotes FDI through acquisitions, mergers and takeovers and the latter implies FDI through fresh investments, which create productive assets and make provisions for concrete inflow of funds. Green-field investment is more beneficial than cross-border mergers and acquisitions (M&A) either through takeovers of existing Domestic Companies or through amalgamations. Such green-field investments add directly to productivity capacity and employment. The essential difference between cross-border M&As and green-field FDI is that the former involve, by definition, a change of assets from domestic to foreign hands and, at least initially, do not add to the productive capacity of host countries. FDI through M&As is less likely to transfer new or better technologies or skills than green-field FDI, at least at the time of entry and also does not generate employment. However, over the longer term most of the short comings of FDI through M&A are taken care of by sequential investments and transfer of new or better technology especially when acquired firms are restructured to increase the efficiency of their operations. Thus, in the longer run, differences between the two modes as regards employment generation tend to diminish and depend more on the motivation for entry than on the mode of entry.

Cross-border M&A transactions represent the invasive face of globalization. They raise important questions of concerns. This is particularly because transnational corporations are the principal beneficiaries of globalization, while local, small and medium industries are adversely affected. It is no accident that popular perception associates M&A activity of the cross-border variety with the expansion and dominance of global big businesses. Cross-border M&As can sometimes lead to creation of large monopolies and reduce competition in domestic manufacturing. Cross-border M&As also lead to the logical concern that control of strategic industries may be lost to foreign acquirers. In this sense, M&As can also threaten national identity, especially when leading industrial groups are taken over.

FDI flows comprise capital provided (either directly or through other related enterprises) by a foreign direct investor to an FDI enterprise, or capital received from an FDI enterprise by a foreign direct investor. There are three components in FDI: equity capital, reinvested earnings and intra-company loans. Equity capital accounted for 72 percent of global FDI inflows and reinvested earnings for 8 percent in 1998[9].

- Equity capital is the foreign direct investor's purchase of shares of an enterprise in a country other than its own.

- Reinvested earnings comprise the direct investor's share (in proportion to direct equity participation) of earnings not distributed as dividends by affiliates or earnings not remitted to the direct investor. Such retained profits by affiliates are reinvested.

- Intra-company loans or intra-company debt transactions refer to short-or long-term borrowings and lending of funds between direct investors (parent enterprises) and affiliate enterprises.

Foreign direct investors may also obtain an effective voice in the management of another business entity through means other than acquiring an equity stake. These are non-equity forms of FDI, and they include, inter alias, subcontracting, management contracts, turnkey arrangements franchising, licensing and product sharing. Data on transnational corporate activity through these forms are usually not separately identified in balance-of-payments statistics. These statistics, however, usually present data on royalties and licensing fees, defined as "receipts and payments of residents and non residents for: (i) the authorized use of intangible non-produced, non-financial assets and proprietary rights such as trade-marks, copyrights, patents, processes, techniques, designs, manufacturing rights, franchises, etc., and (ii) the use, through licensing agreements, of produced originals or prototypes, such as manuscripts, films, etc.[10].

Foreign direct investment is an inclusive term and includes in its ambit-FDI through Joint Ventures & Technical Collaboration, FDI through Financial Collaboration, FDI via Capital Market through Euro Issues and FDI through Private Placement or Preferential Allotment.

Definition of Multinational Enterprises (MNCs)

A multinational or transnational enterprise is an enterprise that engages in foreign direct investment (FDI) and owns or controls value-adding activities in more than one country. This is the threshold definition of a multinational enterprise (MNE), and one that is widely accepted in academic and business circles, by data collecting agencies such as the Organization for Economic Cooperation and Development (OECD), the United Nations Centre on Transnational Corporations (UNCTC) and by most national governments. At the same time, some scholars and practitioners have found it desirable to distinguish between the universe of enterprises undertaking foreign production and those that have substantial overseas commitments and/or pursue an integrated managerial strategy towards their foreign and domestic operations. In particular, business analyst like to distinguish between MNEs that govern a group of largely independent multi-domestic foreign subsidiaries, each of which produces goods and services mainly for the local market, and those that treat their affiliates as part and parcel of a regionally or globally coordinated network of production and marketing activities.

Various kinds of Assets of MNCs

The assets that the FDI bundle comprises are :

- Capital : FDI brings in investible financial resources to host countries. The inflows are more stable, and easier to service, than commercial debt or portfolio investment. In distinction to other sources of capital, TNCs invest in long-term projects, taking risks and repatriating profits only when the projects yield returns.

- Technology : Developing countries tend to lag in the use of technology. Many of the technologies deployed may be outdated. Even if part of their productivity gap is compensated for by lower wages, technical inefficiency and obsolescence can severely handicap the quality of their products and their ability to cope with new market demands. TNCs can bring modern technologies, some not available without FDI, and they can raise the efficiency with which existing technologies are used. They may, in some cases, set up local Research and Developments (R&D) facilities.

- Market access : TNCs can provide access to export markets, both for existing activities (that switch from domestic to international markets) and for new

activities that exploit the host economy's comparative advantages. The growth of exports itself offers benefits in terms of technological learning, realization of scale economies, competitive stimulus and market intelligence.

- Employment, skills and management techniques : TNCs possess advanced skills and can transfer these by bringing in experts and by setting up state-of-the-art training facilities. New management techniques can offer great competitive benefits. Where affiliates are integrated into TNC networks, they can develop capabilities to service the regional or global system in specific tasks across the entire spectrum of corporate functions.

- Environment : TNCs often possess clean technologies and modern environment management systems, and can use them in all countries in which they operate. Some TNCs are in the forefront of adopting high environment standards at home and abroad.

While TNCs offer the potential for accessing these assets in a package, this does not mean that simply opening up to FDI is the best way of obtaining or benefiting from them. As noted, there are market failures in the investment process and divergences between TNC and national interests. This means that governments may have to intervene in the FDI process to attract or promote (specific types of) FDI, or to regulate and guide it[11].

Factors affecting FDI Policies of Host Countries

Factors affecting FDI policy of host country include (i) Information and coordination failures in the international investment process, (ii) Infant industry considerations in the development of local enterprises, which can be jeopardized when inward FDI crowds out these enterprises, (iii) The static nature of advantages transferred by TNCs where domestic capabilities are low and do not improve over time, or where TNCs fail to invest sufficiently in raising the relevant capabilities and (iv) Weak bargaining and regulatory capabilities on the part of host country governments, which can result in an unequal distribution of benefits or abuse of market power by TNCs.

The complexity of the FDI package means that there can be trade-offs between different benefits and objectives. For instance, countries may have to choose between investments that offer short as opposed to long-term benefits; the former may lead to static gains but not necessarily to dynamic ones. A large inflow of FDI

can add to foreign exchange and investment resources in a host economy, but it may deter the development of local firms or create exchange rate problems. The desire to generate employment may lead governments to favour labour intensive, low technology investments, while that to promote technology development may favour more sophisticated investors. Similarly, the desire to upgrade technology may call for a heavy reliance on technology transfer by TNCs, while the desire to promote local innovation and deepening may require more emphasis on arm's length transfers to indigenous firms. There can be many such trade-offs, and there is no universal answer to how they should be made. There is however, no ideal policy on FDI, which applies to all countries at all times[12].

Meaning and Scope of Foreign Portfolio Investment (FPI) and Distinction between FDI and FPI

Foreign investors' interest in a country may result in financial flows either in the form of direct investment or portfolio investment. Foreign portfolio investment takes the form of acquisition of tradable securities either in the primary or secondary market[13]. Foreign direct investment is preferred primarily for the reason that it goes directly to increase the capital formation of the recipient country. FDI implies a more lasting interest and a controlling voice in the management. Cases of frequent disinvestments are not? therefore, they can be more volatile than direct investment. Their impact on capital formation is one step removed. Increased activities in the capital market may act as a spur to further domestic real investment. Sharp increase in portfolio flows also pose certain problems for macro-economic management. However, there is certain complementarity between the two forms of investments. Very often portfolio investment creates a climate of confidence required by the foreign investors and thus paves the way for direct investment.

Traditionally, the territorial expansion of a firm's production outside its national boundaries has been achieved by the act of a foreign direct investment. FDI is different from foreign portfolio (or indirect) investment in two important respects. First, the former involves the transfer of a package of assets or intermediate products, which includes money capital, management and organizational expertise, technology, entrepreneurship and access to markets across national boundaries; the latter involves only the transfer of money capital.

Second, unlike arm's length trade in assets and intermediate products, FDI does not

involve any change in ownership; in other words, the control of decision taking over the use of the transferred resources remains in the hands of the investing entity. To put in another way, while the market organizes the indirect exchange of assets and intermediate products, the direct exchange is administered by, and within, investing hierarchies.

Portfolio investment, as distinct from foreign direct investment (FDI), comprises financial instruments that can be acquired by foreign investors either in the international securities exchanges, the US private placement market, or through direct purchase in the developing country's stock market. These instruments can be classified in two groups: equity and debt instruments.

In principle, FPI is distinguished from FDI by the degree of management control that foreign investors exercise in a venture. Portfolio equity investors usually provide only financial capital by purchasing shares of a company without any involvement in the company's management and has a shorter investment horizon than FDI, say one year or two years. An investment is normally counted as FDI if the equity stake is more than 10 percent, but this limit is somewhat arbitrary. Flows of FPI are intimately linked to the development of stock market in recipient countries. The overriding motivation of FPI is earnings through capital gains and dividend. FPI investors are commonly knows as Foreign Institutional Investors i.e; FIIs and FDI investors as Multinational Corporations or MNCs. It is easier for FIIs to liquidate their investment as compared to MNCs to sell their foreign affiliates and this gives rise to the risk and problems associated with FPI investment due to high volatility involved with it.

The Role and Necessity of Foreign Investment

Economic growth being the objective, the investment function can be activated through one of the following sources – either printing money at Govt. level or borrowing money from internal or external sources or through domestic/foreign savings or by increasing the productivity either alone or with the combination of increase in the investment level. Productivity is a function to increase the growth rate with the same level of investment resources but it depends upon two factors namely Labour Productivity and Capital Productivity. Knowledge and technology keep on influencing the productivity factors. However, we consider total productivity factor (TPF) for the overall efficiency level of all the available resources. Therefore,

combinations of factors i.e. the existing savings, the available resources and technology, the demand and supply factor in the domestic and external economy etc. influence the investment and growth. The existing level of inflation will influence the decision of Reserve Bank of India's efforts to increase money supply. The existing debt service ratio and the interest rates will influence the decision to borrow further money either in domestic or external market. Similarly, the existing level of external debt will influence the decisions of debt or equity investments from the external resources.

In the early stages of planning, and till the late eighties, we depended on external borrowings but once the debt service ratio started deteriorating towards the end of 1990, we made a shift from debt to equity. The debt financing is possible through institutional borrowings under bilateral arrangements with various developed countries and through IMF, World Bank etc., on long-term basis and through Commercial banks on short-term basis. The equity financing on the other hand purely depend on the private sector financing through the route of either foreign direct Investments or portfolio investments in the stock/capital market. Thus the question of allowing investment in the domestic economy takes place.

The financing of gap between the domestic savings and domestic investment by debt option till late eighties did not require any kind of reform measures but the decision to allow foreign investments necessitated a plethora of changes in the Govt.'s policies. Whether we call it an option or compulsion, the situation of our foreign exchange reserve had come to a serious and precarious level in the year 1990[14] when we could hardly afford to import for another one month. We had the limited option to continue with external debts for some more time but that could lead to a situation of debt crisis, which was faced by Latin America countries including Mexico, Brazil and Argentina in 1982. The IMF team, therefore, suggested a series of economic reforms measures and Govt. of India signed an agreement with IMF to accept Structural Adjustment Loans (SAL) on the basis of a policy framework paper to immediately introduce Structural Adjustment Programmes (SAP). The SAP, inter alias, included drastic changes in the foreign investment policies and the doors were opened to invite both the FDI and FPI under the New Economic Policy (NEP) announced by The Congress Govt. of Shri P.V.Narshimha Rao in July 1991.

Therefore, the question of foreign investment is directly linked with the economic reforms. The objective of this study is to analyse the need, the purpose, the risk and the desired extent and proportions of domestic and foreign investment in the domestic economy. The study will seek to examine as to whether the ultimate objectives of sustainable economic growth can be achieved in solving the acute problem of poverty and unemployment of our country by making a comparative study with China, Mexico and South-East Asian countries Foreign investment per se provides external resources, which help to finance the balance of payments deficit without adding to the country's external debt. In this respect, the ability to attract foreign investment promote the objective of self reliance by helping to avoid a build up of external debt which adds to our vulnerability. Apart from providing support for the balance of payments, foreign investment also provides critical access to technology and other types of know how, and also provide potential linkages to world markets. In a world where transnational corporations increasingly dominate trade, it is important to encourage foreign investment as part of the process of modernizing our industry and developing linkages with the rest of the world. Many Indian companies are eagerly seeking foreign investment in joint ventures as part of their plan for technological upgradation and modernisation and these efforts should be encouraged. As the second largest developing economy in Asia, India can be a major destination for foreign investment. Foreign investment policy was re-oriented in the Eighth Plan period to encourage a larger flow of foreign investment into the economy, especially into the infrastructure sectors where a rapid expansion in capacity is urgently needed. Foreign direct investment increased from $ 0.1 billion in 1990-91 to $ 3.5 billion in 1997-98[15].

An aspect of external economic policy, which needs careful consideration, is the pace of liberalisation of the capital account. Globalisation has meant an explosion of financial integration in world markets, with large volumes of capital moving freely across national boundaries. Free access to capital from world market has its advantages, but it also poses dangers to developing countries because of the potential volatility of these flows. This is amply demonstrated by the experience of East Asian countries, which suffered a massive outflow of capital based on a sudden change in international perception about underlying fundamentals in these countries. The outflow precipitated a currency crisis with a severely disruptive effect on these economies. It is important to recognise that East Asia's problems arose not because of open trade policies or openness to foreign direct investment, but because an open

capital account allowed banks and corporations to borrow freely in world markets leading to a large accumulation of short term debt. Weaknesses in the banking sector led to poor inter-mediation of these flows to support unproductive investments, including investment in real estate. When these weaknesses became apparent, the short-term nature of the liabilities led to a reversal of capital flow, which was not easily arrested. A lesson commonly drawn from the experience is that developing countries with weak banking system may be well advised to maintain restriction on short term capital flows to limit the potential danger of sudden and large outflows. The approach to capital account liberalisation followed in India has been cautious, and government policy has been particularly concerned to avoid a build up of short-term external liabilities. This caution is vindicated by the East Asian experiences. External policies should continue the process of cautious liberalisation in the financial sector with particular caution on the build up of short- term debt.

It is necessary to deal with the question as to why foreign investment is necessary for economic growth. Supposing that a backward and underdeveloped country is interested in rapid economic development, it would generally need import of machinery, technical know-how, spare parts and even raw materials. One method of paying for the imports is to step up exports. This is possible, if the Government is prepared to curtail consumption drastically and export more, simultaneously curtailing import of consumption goods. Russia, China and others had adopted this method. As this involves a lot of sacrifice, it can be adopted only by a Government, which is committed to such a policy. The second alternative of getting foreign technology and equipment is to depend upon foreign assistance in some form or the other.

Most countries of the world, which embarked on the road to economic development, had to depend on foreign capital to some extent. The degree of dependence, however, varied with the extent to which domestic resources could be mobilised, the state of the domestic economy in respect of technical progress, the attitude of the respective Governments, etc. However, the fact cannot be denied that foreign capital contributed in many important ways to the process of economic growth and industrialisation.

The need for foreign capital for a developing country like India can arise on account of the following reasons :

148360 19 JUL 2002

North Bengal University Library Raja Rammohunpur

(i) Domestic capital is inadequate for purposes of economic growth and it is necessary to invite foreign capital,

(ii) For want of experience, domestic capital and entrepreneurship may not flow into certain lines of production. Foreign capital can show the way for domestic capital,

(iii) There may be potential savings in a developing economy like India but this may come forward only at a higher level of economic activity. It is, therefore, necessary that foreign capital should help in speeding up economic activity in the first instance,

(iv) It may be difficult to mobilize domestic savings for the financing of projects that are badly needed for economic development. In the early stages of development, the capital market is itself under developed. During the period in which the capital market is in the process of development, foreign capital is essential as a temporary measure and

(v) Foreign capital brings with it other scarce productive factors, such as technical know-how, business experience and knowledge, which are equally essential for economic development.

Bridging Four Gaps

An important issue regarding direct foreign investment is whether it displaces domestic investment or adds to that. It depends on the purpose and application for which it is used. It is now a more accepted view that TNCs are accepted by developing countries since they help the latter to fill four gaps: saving-investment gap, foreign exchange gap, fiscal gap and skills, knowledge technology and management gap. These are basically the four major objectives of foreign direct investments namely : (i) The resource gap between domestic investment and domestic savings, (ii) The foreign exchange or trade gap between foreign exchange requirements and foreign exchange earnings, (iii) The budgetary gap between target revenue and locally raised taxes and (iv) The management and skill gap by providing foreign management and the training of local managers or workers.

In other words foreign investment helps to : (i) supplement domestic savings; (ii) access to latest technology and management techniques, contributing to the training and development of people; (iii) the possibility of improving asset utilisation through better knowledge and skills; (iv) stimulate domestic competition, resulting

in market growth through quality and cost improvement; (v) access to international markets; (vi) contribute to the inflow of foreign currency to redress the trade deficit; and (vii) ensures productivity and profitability that follows.

Major Concepts and Theoretical Framework

Economists have developed several models of conceptual ideas on foreign investment. According to the classical theory as elaborated by Macdougal G.D.A. 1960), Kemp. M. (1961), Ruffin J.R.(1984), the gains of foreign investment approximately equal to the amount of foreign investment times the reduction in the real rate of interest. Foreign investment enhances per capita income of either the capital exporting or capital importing country in proportion to the country's improvement in the terms of lending or borrowing the capital account. For a capital exporting country, the improvement means a lower rate of return. All these models assume that foreign investor does not exploit the domestic labour market to ensure long run growth.

In the neo-classical model developed by Robert Solow (1956) the capital mobility shoot up the assets of either capital exporting or capital importing countries and increases long run per capita income. In his over lapping generation progress, it was found that FDI generates gains even though there is monopolistic exploitation. The model overviewed that foreign investment makes the future generation of the capital importing country better off and the future generations of the capital exporting country worse off.

Since the foreign investment lowers interest rate in the capital importing region, the model explained that the present generation is made worse off. The present generation would be better off if the interest rate rises in the capital exporting region. In the capital-importing region, future generations will be better off because the capital stock is higher causing higher wages. In the capital exporting country, the future generations will be worse off because wages will be lower. Schumpeter, J. (1942), Schmooker, J. (1966) developed the ideas that FDI brings new knowledge and entrepreneurship, empower research and development in technological progress which induce to increase profit. Paul. M. Romer (1990) showed that longer the stock of people capable of carrying out R&D, the larger the rate of growth. Since the human capital is growing, the endogenous growth model (i.e. technological progress is faster, the larger the level of accumulated human knowledge: because

cost of innovation falls as the level of human knowledge increases) implies accelerating growth rates.

In this case the issue is also whether FDI leads to spillover effects of the kind envisaged by the theory of endogenous growth. There are several findings in this regard. Chen E.K.Y. (1983) found that industries that have been recipients of FDI have higher rates of technological progress (e.g. Hong Kong).

Aitaken. S. and Harrison A (1992) found that proximity to FDI had weak effects on domestic firms that were foreign owned at one time. This conclusion does not suggest any norm of productive industries or unproductive industries.

Further modification was analysed by David Gould and Roy J. Ruffin (1992). They explained that the rate of growth (endogenous growth in an open economy) depends jointly on the level of human capital and nature of trade regime. (D. Bhowmik & R. K. Sen) (1995).

Any economic analysis presupposes a model, however informal. The treatment of a controversial issue such as foreign direct investment (FDI) virtually demands an explicit statement.

The approach has had a number of key innovators; the names Dunning, Casson, Buckley, and Caves are at the forefront. Without denying the insights of the Heckscher-Ohlin model of comparative advantage and international production and trade, OLI model asks – why FDI exists and answers it focusing on a number of factors such as transport costs, scale economies, and differing technological levels. Perhaps the key breakthrough in the development of this approach was the 1960 Ph.D. thesis of Stephen Hymer (1976), who first explained FDI combining the classic idea of Coase with Bain's concept of barriers to entry.

Dunning (1980, 1988a), describes it as an "eclectic paradigm" of multinational investment. This model affirms that there will be foreign investment when there are ownership or locational advantages for a firm to produce overseas, which can best be captured by internalization of production through FDI. These considerations of ownership, location, and internalization, are the essence of the OLI model. (Dunning, 1993a).

- The ownership-specific advantages (e.g. proprietary technology) of a firm-if exploited optimally-can compensate for the additional costs of establishing production facilities in a foreign environment and can overcome the firm's disadvantages vis-à-vis local firms.

- The ownership-specific advantages of the firm should be combined with the locational advantages of host countries (e.g. large markets or lower costs of resources or superior infrastructure).

- Finally, the firm finds greater benefits in exploiting both ownership specific and locational advantages by internalization, i.e. through FDI rather than arm's length transactions. This may be the case for several reasons. For one, markets for assets or production inputs (technology, knowledge or management) may be imperfect, if they exist at all, and may involve significant transaction costs or time lags. For another, it may be in a firm's interest to retain exclusive rights to assets (e.g. knowledge), which confer upon it a significant competitive advantage (e.g. monopoly rents).

While the first and third conditions are firm-specific determinants of FDI, the second is location-specific and has a crucial influence on a host country's inflows of FDI. If only the first condition is met, firms will rely on exports, licensing or the sale of patents to service a foreign market. If the third condition is added to the first, FDI becomes the preferred mode of servicing foreign markets, but only in the presence of location-specific advantages. Within the trinity of conditions for FDI to occur, locational determinants are the only ones that host governments can influence directly. Governments can influence the other two conditions but only indirectly—for example, through the promotion of cross-border partnerships in R&D, thereby reducing the imperfect nature of technology markets and thus affecting transaction costs, degree of competition and other elements of ownership and internalization choices. A host of factors are assumed to be important for inducing FDI in a host country. As summarized by Dunning (1973)[16], factors usually included in survey studies fall into the following categories namely :

i) Market factors which not only include market size and growth potential, but also include the ability to maintain market share and the promotion of trade between the subsidiary and parent company,

ii) Trade barriers,

iii) Cost factors, which encompass various factors influencing cost of production (such as labour and the achievement of economies of scale), and the investment climate, which consists mainly of political stability, general attitude towards FDI, incentives and disincentives of host countries and

iv) As Dunning reports, these survey studies 'stress the host government's attitude to inward foreign investment, political stability, and the prospects of market growth as the most important considerations prompting foreign activities' (Dunning 1973)[17].

In summary, Dunning predicted that if a corporation has a firm-specific advantage, is able to internalize this advantage, and can benefit from specific host country attributes, then FDI will occur (Stephen Meyer and Tao Qu).

Kojima K. (1973) studied the circumstances under which FDI would be trade creating or trade reducing. He argued that the former would occur when a firm that possesses superior technology but lacks resources invests abroad in countries with opposite endowments. Similarly, anti-trade, or domestically biased investment, will arise when a host country raises tariffs, attracting overseas investors.

Foreign investment has long played a key role in the theoretical constructs of those critical of the twentieth-century capitalist system. In the early years of the century, Hobson and Lenin asserted that a major economic force behind imperialism was the search for new markets overseas. Its cause was the condition of oversupply and a falling rate of profit at home due to the ever-larger production capacity outpacing a continually diminishing domestic purchasing power, itself squeezed by a steady worsening of the distribution of income. The Hobson-Lenin analysis was influential for its emphasis on economic as opposed to military or political explanations of imperialism.

Foreign direct investment depends on both economic and political factors. Rana P. B. (1988) explained four models related to those factors, namely :

i) The economic model hypothesized that FDI per capita was influenced favourabely by real GNP per capita and growth rate and negatively by the current account balance and inflation rate.

ii) The political model specified that FDI is function of number of strike, a proxy for political instability etc.

iii) The political economic model analysed all variables and

iv) This is an amalgamated model where FDI is a function of general investment climate proxied by the institutional investor credit rating index.

Lim Chung Yah (1988) found several advantages of FDI over commercial loans. FDI is packaged incorporating not only financial capital and foreign exchange but also production management and marketing capabilities. It reduces the risk of export-oriented industrialisation for infant industrial economies. The entrepreneurial risking function is borne by the foreigner. Profitibility and outward remittance of profit and dividends move in close tandem with performance of the economy and B.O.P.The other benefits of FDI as advocated by Lall Sanjay (1993) are :

i) FDI provides continuous access to change in new technology.

ii) It can import new managerial and marketing skill, stimulate domestic competition.

iii) It helps local supplies, improves quality and competitiveness.

iv) Developing countries can participate in sophisticated technologies with the alliance of MNC.

v) FDI benefit can be maximised only in relatively free and market oriented environment.

vi) FDI carries the largest risk.

vii) It provides large economies of scale implying R and D and

viii) Joint venture with foreign investors can stimulate technology.

According to Lin Chung Yah (1988), the FDI have possessed some fundamental disadvantages which are :

i) FDI brings foreign ownership and control over economy which may lead to surrender of national sovereignty.

ii) FDI dominance may crowd out domestic private enterprise.

iii) FDI are not attracted to stagnate or depressed economies since it need only good rate of return. and

iv) FDI has risk exposure from commercial loan.

There is no guarantee that foreign direct investment must benefit host countries, government policies play a crucial role in ensuring that foreign investment constitute

positively to economic development and benefits are maximised (Chen. K.Y.1993).

Chen. emphasized that Government Policies towards FDI should follow through some definite economic backgrounds such as: export - oriented industrialisation, excellent infrastructure, stable macro economic environment, outward looking strategy (rapid transformation from primary to secondary industry), privatisation of industries and services, rapid growth of domestic economies, exemption of taxes and movement towards free trade.
Chen suggested that the government should follow structural adjustment policies in successive stages of reform. To attract more FDI, Govt. can set up more EPZ, SEZ to create general investment environment along with financial stability, which need stable monetary and exchange rate policy.

To keep up pro FDI policies, a Government should have certain requirements which may lead to higher growth (Chen, 1993) such as : political, social and economic stability, a buoyant growing domestic market, the Government applying laws free for FDI, a quick movement towards policies of liberalisation, a gradual improvement of human resources and infrastructure, observing for a movement of favourable factor endowment and motivating common effective preferential tariff with blocs/ non-blocs.

Findlay (1978) postulates that foreign direct investment increases the rate of technical progress in the host country through a "contagion" effect, from the more advanced technology, management practics etc used by the foreign firms. Wang (1990) incorporates this idea into a model more in line with the neoclassical growth framework, by assuming that the increase in knowledge applied to production is determined as a function of foreign direct investment (FDI).

Empirical research results by a team of Natural Bureau of Economic Research (NBER 1995), suggests that FDI is an important vehicle for the transfer of technology, contributing relatively more to growth than domestic investment. However the higher productivity of FDI holds only when the host country has a minimum threshold stock of human capital. In addition, FDI has the effect of increasing total investment in the economy more than one for one, which suggests the predominance of complementary effects with domestic firms.

The NBER research (ibid.) further investigate the effect of FDI and domestic investment, namely whether there is evidence that the inflow of foreign capital

"Crowds out" domestic investment. The study shows in contrast a "crowding in" effect, that is, a one-dollar increase in the net inflow of FDI is associated with an increase in total investment in the host economy of more than one dollar. The values of the point estimates place the total increase in investment at between 1.5 and 2.3 times the increase in the flow of FDI. Thus, in addition to its effect on technological progress, it appears that FDI contributes to economic growth by increasing total capital accumulation in the host economy. This study shall also examine the above empirical study in the context of Indian situation.

The phenomenon of economic growth is complex, and the lines of causation frequently go both from supposed causes to growth and from growth to the supposed causes. Furthermore, the various factors that are thought to explain growth are themselves interrelated. These problems face all studies attempting to throw light on whether, in what way, and to what extent a particular factor or group of factors affect growth. They similarly apply to study of the impact of FDI on growth. Capital formation may be affected by FDI inflows, because they are a source of financing. Inward FDI may increase host country productivity and exports, and productivity growth may affect exports. Host country institutional characteristics, such as the legal system, enforcement of property rights, and the extent of corruption, that have been suggested as explanations for differences in growth rates, are likely to influence also the extent of inward FDI and capital formation.

The search for explanations of growth has been pursued in several different ways. Many of the earlier studies, such as those of Kuznets, traced the long-term growth of countries, mostly those that were, at that time, developed. Few developing countries at that time had data extending over long periods for even a few of the standard aggregate measures commonly used in research. After World War II there came a worldwide expansion and international standardization of national accounting systems, eventually covering almost every country. The United Nations International Comparison Programme (ICP) began in the 1970s to provide real income and price comparisons across countries, including developing countries. These were the raw material for a series of papers by Summers and Heston and the accompanying Penn World Tables that underlay a large outpouring of studies of economic growth, especially growth in developing countries.

The few long-period cross-section growth studies that included FDI as a variable tended to find some positive relationship. For example, one study reported a significant relationship between inflows of FDI as a percentage of GDP and the growth of per capita GDP across all developed countries for the period 1960-1985 (Blomstrom, Lipsey, and Zejan, 1994). It suggested that although the gap in technology and productivity between foreign-owned firms and locally owned ones is larger in poorer countries than in richer ones, that does not necessarily mean that the poorer countries gain the most from inward FDI. It argued, "the least developed countries may learn little from the multinationals, because local firms are too far behind in their technological levels to be either imitators or suppliers to the multinationals". And it found, in confirmation of this supposition, that inflows of FDI were significant as determinants of growth for the upper half of the distribution of developing countries, by per capita income, but not in the lower half.

A similar conclusion was reached in a study for 69 developing countries of growth in per capita GDP from 1970 to 1989 (Borensztein, Eduardo, Jose De Gregorio and Jong-Wha Lee, 1995). The FDI variable in that study was the inflow of FDI to these countries from the presumably more advanced ones that made up the OECD. FDI itself was a marginally significant positive influence on growth, but FDI interacting with a measure of average educational attainment was a stronger and more consistent influence. The higher the level of education of the labour force, the greater the gain in growth from a given inflow of FDI. An interaction between FDI and education was also found in a paper on FDI in China that concluded that "Education becomes even more effective when it is associated with foreign knowledge ... the interaction between school enrolment rates and foreign investment is significantly positive, suggesting mutual reinforcement between domestic human capital and foreign knowledge that accompanies the investment." However, "the coefficient on foreign investment becomes negative when the interaction term is introduced, implying that much of the power of foreign knowledge may come through the local base of human capital" (Mody, Ashota and Fund-Yi Wang, 1997).

Very few long-period cross-section studies have included a measure of FDI as a potential source of growth (Blomstrom, Lipsey, and Zejan, 1994; and Borensztein, De Gregorio, and Lee, 1995). Reflecting this, a comprehensive review of variables used in such studies did not include FDI (Levine, Ross and David Renelt, 1992).

However, some of the variables identified in these studies as factors of growth are typically under the influence of FDI. For example, relatively "robust" relations were found between investment ratios (investment/GDP) and growth and between investment ratios and trade ratios. But, both investment ratios and trade ratios could be affected by FDI flows, and thus, indirectly form a channel for an effect of FDI on growth. Another example refers to the effects on growth of knowledge spillovers (Eaton and Kortum, 1994 and 1995 and Coe and Helpman, 1995). FDI is also a plausible vehicle for these knowledge spillovers, by itself (through R&D, for example) and through its relation to the intensity of trade.

Time series studies focused initially on the impact of FDI on domestic investors. In an early example, relating to Canada, some regression coefficients, taken at face value, implied that "$1.00 of direct investment 'led to' $3.00 of capital formation" (Lubitz 1966, pp.97-98). A later study of FDI into Canada, with somewhat different methods, a slightly longer time span, and annual rather than quarterly data, found a positive direct effect on capital formation greater than the amount of the FDI (Van Loo, 1977). That is, there was some complementary effect on fixed investment by domestic firms. However, when indirect effects through impacts on other variables, such as exports (negative), imports (positive), and consumption (negative), operating through the accelerator, were added, the addition to total capital formation was much smaller, a little over half the inflow. The offsetting negative effects on domestic investment are quite model-specific, and involve accepting plausible, but statistically insignificant, coefficients.

Long-period analyses of growth face endogeneity problems, particularly uncertainty about the direction of causation between growth and investment ratios. In an attempt to avoid some of these problems, in one analysis, the period since 1970 was broken into five-year sub-periods that high growth led to high subsequent investment ratios than for the opposite relationship. In equations including (among others) contemporary or previous period fixed investment as a right-hand side variable, FDI appeared as a positive and significant influence on a country's rate of growth. However, the level and significance of the FDI coefficient fell when the following period's investment was included, suggesting that FDI in one period may have affected host country capital formation in the following period. When the equations were formulated so as to eliminate the cross-section influences by dividing each variable by its long-period average, the influence of the FDI variable disappeared.

In other words, the influence of FDI was evident only in the cross-section; higher FDI in a period did not have any visible influence on growth in that period in a given country, although across countries, those with higher ratios of FDI to GDP were also those that grew faster.

The internalization theory, that is currently used to explain the international operations of the firm, suggests that transfer of intangible assets (e.g., technology) will be made through FDI (or internal mode) only if costs of market transaction are high (Buckley and Casson 1976; Dunning 1979, 1993). If the transaction costs are not high, the technology transfer could take place through arm's length licensing which in Indian parlance is referred to as purely technical collaborations.

Among the factors that determine the distribution of these flows across developing countries various empirical studies (e.g., Root and Ahmed (1979); Scheneider F. and Frey B.S. (1985) have pinpointed per capita income, growth rate, extent of urbanization, availability of infrastructure, political uncertainty and BOP problems. In light of these findings, low income agrarian economies with BOP problems are likely to attract lower magnitude of FDI than middle income newly industrializing economies (NIEs) with high levels of urbanization. Policy incentives and liberalization have been found to be of limited significance in affecting a country's attractiveness for FDI. During the late 1970s and 1980s a large number of developing countries undertook policy reforms to attract a greater magnitude of FDI. Contractor F. J. (1990) in an empirical study of 46 countries did not find liberalization to be an important factor in influencing the pattern of FDI flows.

The foreign investor's response was found to be strongly influenced by the size and growth of the host economy rather than by changes in the government's FDI policies. Another exercise by Wheeler and Mody (1992) covering 42 countries for the period 1982 to 1988 emphasized the importance of the quality of infrastructure, level of industrialization and market size in attracting US FDI. The open market policies or incentives, such as tax breaks were found to be of limited value in determining the investment decisions of US MNEs.

FDI creates technological externalities – knowledge spillovers or demonstration effects – for the local economy. Econometricians searching for such effects have found evidence that the presence of FDI has a positive effect on domestic firm's total factor productivity and on their propensity to export[18].

Case study findings in Hobday, M.G. (1995) reflect a large number of situations in which initial investments by developed country multinationals in developing East Asia created backward linkage effects to local suppliers. Interesting examples include computer keyboards, personal computers saving machines, athletic shoes and bicycles in Taiwan. The initial foreign investments created demand for local suppliers and improved their quality, productivity and product diversity. Hundreds of local firms entered to supply components or assembly services to multinational firms. This growth of component and other intermediate goods supply and productivity in turn created a subsequent forward – linkage effect to the final goods producers, drawing in more multinationals and domestically owned firms. In some cases (e.g. bicycles and computers) local firms eventually displaced the original multinational entrants into Bibliography.

In a recent study made on FDI in Global Competition Report 1997, the World Economic Forum (WEF) has examined two alternative empirical models for FDI. The sample for the cross-country regression analysis included 53 countries, and the sample period was 1990-96. In the first regression, the dependent variable was the average ratio of FDI to Gross Domestic Product (GDP), and the independent variables included the host country's market size, as measured by its GDP, at the beginning of the period; a measure of the openness of the host country's economy to capture the influence of trade barriers, like tariffs and quotas, and the foreign investor's ability to repatriate profits and dividends; and the degree of protection of intellectual property rights (IPRS) in the host country.

Econometric analysis, and the Survey's results, has important implications for any country's economic policies. It is instructive to note that foreign investors do not particularly care about the things that used to be considered important: corporate tax rates and structure, tax holidays, cheap credit, subsidies, and other types of investment incentives. In the past, governments eager to attract FDI have introduced generous incentive schemes, sometimes adversely affecting the national government's fiscal revenues.

The Survey's results cast doubts about the effectiveness of such investment-promotion policies. The important message here is that governments should concentrate on reforms that improve institutions and economic policies and, thus, create an environment conducive to private investment and economic growth. Public investment in education and infrastructure can raise the productivity of

private capital and the workforce. It will therefore, also help attract FDI inflows (Hu Frederick 1997).

In yet another recent study after the South East Asian crisis on foreign portfolio investors (FII's) trading behavior during the crisis period, by analyzing the data in the Korea Stock Exchange, Kim Woocham and Wei Shang-Jin (1999) has concluded with a number of findings. First the domestic institutional investors who were negative feedback traders before crisis period switched to become positive feedback traders during the crisis period. In contrast the non-resident Institutional Investors or the FII's have been consistently engaged in positive feedback trading and the tendency is reinforced during the crisis period. Second, individual investors were significantly more than institutional investors and non-resident investors (institutional as well as individual) herd significantly more than their resident counterparts. Third, major Western and Korean papers carry different numbers of good news relative to bad news about the Korean economy. For example, in the months leading upto November 1997, the Western papers reported relatively more bad news. This difference in norms is corrected with the difference in the net selling of the Korean stocks by the non-resident investors relative to their resident counterparts.

While establishing a correlation between the level of corruption in the host country and the reluctancy of foreign investment Smarzynska and Wei (2000) has tried to establish that a foreign investor's choice of the entry mode is affected by the investor's technological sophistication and the extent of corruption in the host country. Corruption makes local bureaucracy less transparent and hence increases the value of a local joint venture partner to a foreign investors. On the other hand, foreign investors with sophisticated technology may worry about leakage of technological know-how by joint venture partners and are thus less inclined to form joint ventures. In addition the study also finds that, other things being equal, American investors are somewhat more reluctant to form joint ventures in more corrupt countries possibly because of the U.S. Foreign Corrupt Practices Act, of 1977 Beate K. Smarzynska and Wie Shang-Jin (2000).

"Assaf Razin, E fraim Sadka and Chi-Wa Yuen (2000), has tried to draw the implications of two extreme cases regarding the information possessed by the firm at its financing stage for whether foreign debt flows may crowd out foreign equity

flows or the other way round. The study demonstrates that there is a severe "home bias" problem concerning equity flows. However when the two mechanisms are blended, equity flows will crowd-out debt flows.

MNCs have to make a choice between exporting, foreign direct investment and licensing as methods of servicing foreign markets.The modern theory of FDI suggests that the MNC develops in response to imperfections in the goods or factor markets. Then country specific advantage of a nation – which leads to trade – is replaced by a firm specific advantage internal to an MNC – which leads to FDI. When there is an advantage specific to a firm, such as knowledge or other special information, it can be transported between the home and host nation within the internal market of MNC. The MNC is a substitute for free trade, in the rigorous terms of economic theory. (Rugman 1981)

Seyoum (1996) has made a study on the corelation between the intellectual property rights (IPR) protection and the inflow of FDI. The study concludes that in case of a developed country FDI inflow increases if the protection to IPR is reduced. There is some support for this finding in the literature. Turkey abolished process/ product patent protection for pharmaceuticals in 1961 to reduce foreign-exchange losses and high prices. However, the amount of FDI in the pharmaceutical sector rose dramatically. Strong IPR protection on the other hand appears to have a positive influence on FDI in countries in which the economic environment is less favourable for investment and in which there is limited industrial and technological infrastructure. This means that developing countries have to strengthen their intellectual property regulatory regime if they are to attract greater levels of FDI. FDI in the developed countries tends to be in research – intensive sectors which are less influenced by the availability of resources or market size.

The Purpose of the Study

The purpose of this study is to establish the link between the need and necessity of foreign capital and economic growth on the one hand and the impact of foreign capital on the domestic industry, the exchange rate, the capital market by drawing a distinction between the role of foreign direct investment and the foreign portfolio investment taking examples and experience of China, Mexico and South East Asia. The study shall also deal with the role of economic reforms on the flow of foreign investment in these countries. The major thrust of this study would be to explain

the Indian case and examine whether Economic Reforms have ushered a new era in India to guide the economy to a sustainable growth path or has acted as a paradox in a changed regime. Another important question to be examined in the study would be as to whether capital controls or prudential measures can limit short term and potentially volatile capital inflows before a crisis erupts particularly in view of Mexican crisis of 1994 and South-East Asian crisis of 1997.

Plan of the Thesis

The thesis follows in eight chapters. Chapter II presents a global view of the FDI stock and FPI stocks and their flows in the developing economy particularly Latin America and Asia vis-à-vis the linkage of globalisation with economic reforms in the developing economies and the inflow of foreign investments. Chapter III provides an insight of the background of Indian economy in the pre-reform period and the policies followed for foreign investment since independence in 1947 till 1990. Chapter IV deals with the actual flows of FDI and FPI during the reforms period between 1991 to 1997 and its impact on the economic growth of the country, the linkage between the reforms and the inflow of foreign investments and an analysis about the distribution of FDI in various sectors of the economy and its regional spread, the impact of FPI in the Indian capital market, its volatile ness and the risk involved in the Indian currency fluctuations. Chapter V deals with the impact of FDI in the Chinese economy and how People's Republic of China has been successful in attracting more FDI than India by making a comparative study between the economic policies and economic scenarios of the two countries. Chapter VI deals with the Mexican experience particularly the currency crisis of 1994 and the lessons India should learn from Mexico, particularly hot money movement, the impact of FPI on the capital market and the currency fluctuations and how a strong economy plunges into a currency crisis when capital account convertibility is allowed to the domestic investors. Chapter VII deals with the South-East Asian Countries experiences of 1997-98 economic crisis. How did the tiger economy melt down and its contagion effect, the manner in which the crisis which originally triggered in Thailand, passed soon to Malaysia, Korea and Indonesia and, therefore, what precautions India should take for preventing such type of crisis which disproved all prudential thoughts and predictions of IMF and other leading International economic research agencies. Chapter VIII presents a comparative analysis based upon statistics and data over the reform period in India in order to arrive at certain conclusions about the linkage between the foreign

investments and economic growth and other select countries namely China, Mexico and crises hit five countries of South-East Asia. Chapter IX presents some concluding remarks about the thesis on the basis of the analysis drawn from the theoretical framework of earlier studies and on the basis of statistical analysis and the experience of the economic reforms measures over the initial period of reforms in India.

Summary and Conclusions

It is evident from the preceding analysis, FDI inflows can supplement domestic financial resources for development and can add, directly or indirectly, to domestic investment in host developing countries. They bring foreign exchange that adds to host countries' balance-of-payments receipts. TNCs can undertake investment projects that may be beyond the reach of domestic investors. But they can also have a number of negative effects, such as crowding out domestic investors and, through transfer pricing, shifting funds out of the host country. In distinction from national enterprises, TNCs may remit profits they earn on investment projects in a host country in the form of dividends (rather than reinvesting them), adding to the country's balance-of-payments expenses. While all developing countries try to attract FDI for the purpose of supplementing their domestic financial resources, FDI inflows still do not have a major influence on total investment in most developing countries: in fact for all developing countries the ratio of FDI to gross domestic capital formation averaged only seven per cent over the 1991-1997 period.

To attract FDI and benefit from it, governments take a range of measures. One of the first things governments wishing to attract FDI can do (and should do) is to establish an enabling policy framework for FDI. Of course, they need to recognize that the FDI policy framework is but one of the factors that attract FDI inflows. It is a necessary but not a sufficient condition to influence locational decision. Business facilitation measures – the efficiency and efficacy of the administrative system that impinges on the entry and operations of TNCs, as well as investment promotion (including incentives available to foreign investors) – can also influence FDI inflows. Once a regulatory framework is enabling, however, TNCs are attracted primarily by economic factors such as the size and growth of the domestic and regional markets and the availability and cost of resources, ranging from natural resources through unskilled, semi-skilled and skilled labour to physical infrastructure (UNCTAD 1998)[19].

There is no "one-size-fits-all" best-practice FDI policy framework that is appropriate for all countries. The subsequent text discusses briefly a number of issues relating to the main components of the FDI policy framework: policies and regulations of FDI; their implementation; promotional measures; and targeting. Each of these three components affects the attractiveness of host countries to foreign investors and hence the flows of FDI.

Recognizing that FDI can contribute to economic development, all governments want to attract it. Indeed, the world market for such investment is highly competitive, and developing countries, in particular, seek such investment to accelerate their development efforts. With liberal policy frameworks becoming commonplace and losing some of their traditional power to attract FDI, governments are paying more attention to measures that actively facilitate it. Still, the economic determinants remain key. What is likely to be more critical in the future is the distinctive combination of locational advantages and, especially, created assets that a country or region can offer potential investors.

As the development process started, the emphasis was on the accumulation of capital. Domestic capital formation was the primary concern not only in India but also in all developing economies. Many countries in the world have now gone well beyond the savings – investment limit of 15 per cent. India's saving rate has ranged between 21 and 24 per cent in the recent period, while the investment rate has varied between 22 and 26 per cent[20].

Finally, it should be remembered that there are many constraints on the development process. Lack of adequate capital is one among them, albeit, an important one. However, even in relation to capital, with the rise in the level of investment rate the emphasis has shifted to productivity of capital. Productivity is the relationship between the quantity of inputs employed and quantity of output produced. An increase in productivity means that more output can be produced with the same inputs. Single factor productivity measures examine the output for one unit of input such as labour or capital with other inputs changing.

Notes and References :

1. *From 1858 to 1898 the total amount transferred is estimated to be more than £1,000 million. From 1898 to 1939, the transfers more than doubled. Add to this what was transferred till 1947, Bagchi, A.K., "British Imperialist Exploitation of India", Economic & Political Weekly.*

1a. *See, B.Chandra, Nationalism and Colonialism in Modern India, Orient Longnan, Delhi 1979.*

2. *World Investment Report : The Triad in Foreign Direct Investment, The United Nations Conference on Trade and Development, Geneva, 1991.*

3. *See, Bimal Jalan, "India's Economic Policy," Viking Penguine India, New Delhi, 1996, Pg.106-107.*

4. *India Development Report Pg.36, (1999-2000) Parikh (1999).*

5. *Figures taken from Eighth Five Year Plan Vol.I, Pg.133, Ghosh (1999) and Ninth Five Year Plan, Vol.I, Govt. of India, Pg.24.*

6. *Economic Times, Calcutta Edition, August 18, 1998.*

7. *John Eatwell et al ,ed. A Dictionary of Economics, Vol.-2 Macmillan 1998.*

8. *This general definition of FDI is based on OECD, Detailed Benchmark Definition of Foreign Direct Investment, second edition (Paris, OECD, 1992) and International Monetary Fund, Balance of Payments Manual, fifth edition (Washington, D.C., IMF, 1993).*

9. *World Investment Report 2000,page, 15.*

10. *International Monetary Fund, op. cit., p,40 and World Investment Report 1999 P.466.*

11. *World Investment Report 1999, Pg-317.*

12. *World Investment Report 1999, Pg.317-318, New York and Geneva, United Nations.*

13. *"Foreign Institutional Investor" means an institution established or incorporated outside India which proposes to make investment in India in securities; provided that a domestic asset management company or domestic portfolio manager who manages funds raised or collected or brought from outside India for investment in India on behalf of a sub-account, shall be deemed to be a foreign institutional investor. (As defined by Securities and Exchange Board of India, Foreign Institutional Investments Regulations, 1995.Foreign portfolio investment (FPI) is decomposed as investment through GDR/ADR (Global/ American depository report), and FII (foreign institutional investors).*

14. *See, Table-XIV at Chapter-IV for details.*

15. *See, Table-III at Chapter-IV for details.*

16. *Dunning J.H.(1973). The determinants of international production. Oxford Economic Papers, 25(3), Pg.297.*

17. *Dunning J.H.(1973). The determinants of international production. Oxford Economic Papers, 25(3), Pg.295.*

18. *Studies include : Aitken and Harrison (1994), Aitken, Harrison and Lipsey (1995), Aitken Hanson and Harrison (1994), Blomstrom (1991), Blomstrom and Kokko (1995), Blomstrom, Kokko and Zejan (1994), Blomstrom, Lipsey and Zejan (1994), Blomstrom and Woff (1994), Haddad and Harrison (1993), Kokko and Blomstrom (1995), Blomstrom and Kokko (1995) providing a good survey.*

19. *United Nations Conference on Trade and Development, New York and Geneva, 1998.*

20. *See Table-XIV at Chapter-IV for details.*