International Journal
of
Research in Finance and Management

P-ISSN: 2617-5754
E-ISSN: 2617-5762
IJRFM 2019; 2(1): 74-79
Received: 12-11-2018
Accepted: 19-12-2018

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# Role of foreign direct investment in industrial development in India

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**Abstract**
India is one of the developing countries which have introduced a liberalization policy and part of it has relaxed the FDI regulatory framework on selective basis with reference primarily to the industrial sector since 1991. The FDI plays an important role in Indian economy and it is a non-debt creating long- term private capital. It also provides a stimulus to competition, innovation, savings and capital formation and enhances job creation, industrial growth and economic development. The economists believe that the impact of the FDI is positive, since it brings to the developing countries a package of capital, foreign exchange, technology, managerial expertise, skills and other inputs which are critical for the development on Indian economy. The FDI will improve the international equality in allocating capital. Capital formation through Foreign Investment plays an important role in the development of industry.

**Keywords:** Important role, Indian economy, long- term, competition, innovation, exchange

## Introduction

Capital formation through Foreign Direct Investment plays an important role in the development of an industry. In the absence of enough domestic saving, external capital plays a vital role in providing the much needed resources for adequate capital formation in the country. Foreign capital plays a significant role even when the country has sufficient domestic capital formation. The process of Industrial development or production process requires not only capital but also some essential imported raw material. Sometimes, sophisticated technology or technical know-how, determines the productivity of capital, which may not be available within the country. Imported raw material, advanced technology, improved machinery, and technical know-how can be brought in, only by way of paying foreign exchange for such purchases. Development in export may not be sufficient to meet out the requirements of foreign exchange of the country. The requirements for foreign exchange gap and requirements of resources,

The international financial market is also affected by the FDI flows. The FDI has emerged as the most important channel of external resources transfer to developing countries like India in the 1990s. The FDI had also acted as an agent of integration of economic activities across the countries in the 1990s. The FDI inflow had grown at an average annual rate of 20 percent over 1991-95 and at 32 percent during 1996-99. The FDI inflows are expected to be less volatile and non-debt creating. They are also expected to be accompanied by a number of other assets that are valuable for development, such as technology, organizational skills, and sometimes even market access among others.

## Review of Literature

Froot and Stein (1991) [5] in their study titled ― Exchange Rates and Foreign Direct Investment - An Imperfect Capital Market Approach examined the effect of exchange rates on the FDI with respect to change in the bilateral level of the exchange rate between countries and in the volatility of exchange rate. An appreciation of a firm‘s home country‘s currency would lower the cost of assets abroad and would lead to actual increase in the foreign investment by a firm abroad.

Campa (1993) [4] in his Research paper ―Entry by Foreign Firm in the US under Exchange Rate Uncertainty, found that greater exchange rate uncertainty increased the option for firms to wait until investing in a market depressing current FDI. The author examined the evidence for this using data on FDI into the US in the wholesale industry.

Bajpai and Sachs (1999) [3] in their research paper titled ―The Progress of Policy and Variations in Performance at Sub-national Level in India outlined that overdependence on agriculture and regional disparities between developed and backward states had created a ―bandwagon effect‖ and forced the FDI only in certain areas, segments, and sectors of the economy.

Hanson, *et al*, (2003) [2] in their empirical study titled ―Vertical Production Networks in Multinational Firms, found that, documents a tendency for the multinationals to concentrate production in low-wage countries.

Baltagi *et al*, (2007) [1] in their study titled ―Estimating Models of Complex FDI: Are There Third-country Effects? revealed that, RTA increases FDI up to by 78 percent among European countries.

**Background of FDI and perspective of Industrail development**

The last two decades of the 20th century witnessed a marked change in the attitude of global market and there was a dramatic worldwide increase in Foreign Direct Investment (FDI). Indian economy, which initiated the progressive liberalization in July 1991, witnessed consistent expansion in the role and functions of the Department of Industrial Policy and Promotion. From formulation of regulation and administration of the industrial sector, the role of this Department has moved to facilitation of foreign technology and foreign investment flows and promotion of industrial development in the liberalized environment. A clear picture of Industrial growth before and after independence, During the British period the importance was given to intermediate goods than other goods. British government crushed Indian industries and promoted British goods and services in Indian market. After independence, the Indian government was not able to provide necessary financial and technology support to promote Indian industries. Thus industrial developments were slow during the period. In order to accelerate industrial growth, Government of India introduced five year plans and each plan period importance was given to different sector to achieve the collective objectives of the country.

**Government policies towards FDI**

The Government of India recognizes the importance and the key role of Foreign Direct Investment (FDI) in industrial development particularly and economic upliftment in general. The FDI plays a role not only as an addition to domestic capital but also as an important source of technology and global best practices in India. The Government of India has put in place a liberal and transparent FDI policy. FDI up to 100% is allowed under the automatic route in most sector / activities. The Government of India reviews the FDI policy on an ongoing basis.

**FDI in India**

The Indian economy opened up its door for foreign investment in 1991 by introducing new economic policy within the frame work of liberal economic reform. The FDI was stimulated in industry and services, benefitting many comparative advantages like availability of skilled labour, English speaking skills, emerging market, availability of ancillary supporting industries and the like. In September 2008, India‘s accumulated amount of the FDI inflows reached Rs.4,03,838 (US $ 96425 million) out of that Mauritius and the USA contribution were more when compared to the investment from other countries. In parallel, some Indian companies started to grow in importance by investing abroad, due to their financial means, experience, and ambition to acquire international recognitions and they were encouraged by the Indian government.

**Table 1:** Deals with details of the FDI ownership limits and entry routes into India.

| Sectors | Ownership Limit | Entry Route |
|---|---|---|
| **INFRASTRUCTURE** | | |
| **Power** | 100% | Automatic |
| **Telecom** | 74% | |
| Basic, cellular and value-added services | | |
| ISP with gateways | 74% | FIPB beyond |
| ISP without gateways | 100% | FIPB beyond |
| Email Voice mail | 100% | FIPB beyond |
| Radio Paging | 74% | FIPB beyond |
| End to End Bandwidth | 74% | FIPB beyond |
| Infrastructure Providers providing Dark Fiber | 100% | FIPB beyond |
| Telecom Manufacturing | 100% | Automatic |
| **Roads** | 100% | Automatic |
| **Ports** | 100% | Automatic |
| **Civil Aviation** | | |
| Airports | 100% | FIPB beyond |
| Domestic Airlines | 49% | Automatic |
| **Petroleum & Natural Gas** | | |
| Petroleum refining | 100% | Automatic |
| Petroleum product pipelines | 100% | Automatic |
| Petroleum product marketing | 100% | Automatic |
| **Others** | | |
| Mass Rapid Transport System | 100% | Automatic |
| EOU/SEZ/Industrial park construction | 100% | Automatic |
| Satellite establishment and operation | 74% | FIPB |
| **SERVICES** | | |
| **Banking** | | |
| Indian Private Banks | 74% | Automatic |
| PSU Banks | 20% | |
| NBFCs | 100% | Automatic |
| **Insurance** | 26% | Automatic |
| **Real estate and construction** | | |
| Townships | 100% | Automatic |
| Housing | 100% | Automatic |
| Construction – Development Projects | 100% | Automatic |
| Build up Infrastructure | 100% | Automatic |
| **Trading** | | |
| Retail Trade | 51% | FIPB |

| Sectors | Ownership Limit | Entry Route |
|---|---|---|
| Trading (Export House, Super Trading House Star Trading House) | 51% | Automatic |
| Trading (Export Cash and Carry) | 100% | FIPB |
| **Tourism** | | |
| Hotels restaurants beach resorts | 100% | Automatic |
| Tour and travel agencies | 100% | Automatic |
| **Broadcasting** | | |
| TV software production | 100% | |
| Hardware facilities - (Up linking, HUB, etc.) | 49% | |
| Cable network 49% | 49% | |
| DTH | 20% | |
| Terrestrial Broadcast FM | 20% | |
| Terrestrial TV Broadcast | Not Permitted | |
| **Print Media** | | |
| Scientific/Technical journals | 100% | |
| Other non-news/non-current affairs/specialty publications | 74% | |
| Newspapers, Periodicals dealing with news and current affairs | 26% | |
| **Other Services** | | |
| Advertising and Film | 100% | Automatic |
| Courier services | 100% | FIPB |
| Lottery Betting and Gambling | Not Permitted | — |
| Defence and Strategic Industries | 26% | FIPB |
| R&D activities | 100% | Automatic |
| **MANUFACTURING** | | |
| Metals | 100% | Automatic |
| Textiles and Garments | 100% | Automatic |
| Electronics Hardware | 100% | Automatic |
| Chemicals and Plastics | 100% | Automatic |
| Automobiles | 100% | Automatic |
| Auto Components | 100% | Automatic |
| Gems and Jewellery | 100% | Automatic |
| **Food and Agro Products** | | |
| Food Processing | 100% | Automatic |
| Agriculture (including contract farming) | Not Permitted | - |
| Plantations (except Tea) | Not Permitted | - |
| **Other Manufacturing** | | |
| Items reserved for Small Scale | 24% | Automatic |
| **RESOURCE BASED SECTORS** | | |

| Coal and Lignite | | |
|---|---|---|
| Sectors | Ownership Limit | Entry Route |
| Coal Processing | 100% | Automatic up to 50% |
| Captive Coal mining | 100% | Automatic |
| **Other Mining and Quarrying** | | |
| Mineral Ores | 100% | Automatic |
| Diamonds and precious stones | 100% | Automatic |
| Atomic Minerals | 74% | FIPB |
| **Oil and Natural Gas Exploration** | 100% | Automatic |
| **KNOWLEDGE BASED ECONOMY** | | |
| Pharma, Healthcare and Biotech | 100% | Automatic |
| Information Technology | 100% | Automatic |

**Source:** www.dipp.in

**Statement of the problem**

For a long period of time, the FDI was used by colonial power to exploit the Indian resources. The sector that received such investment was mostly used in export sectors, and this led to an enclave type of investment. Before liberalization, India was lacking significantly in capital, technology, skills and entrepreneurship. But in India, there is a gap between the volume of the FDI approval and the actual flows (around 22 per cent) resulting in the much added pressure on Indian foreign exchange reserve for financing its development needs in general and its industrial need in particular. Therefore, it is necessary to analyze the factors that have impeded the inflow of the foreign investment. An analysis of the determinants of FDI inflow into India would help to fill up this gap between the actual and the approvals.

**Scope of the study**

The present study aims to analyze some issues connected with the current FDI inflows into India. The study further analyzes the impact of the FDI on the growth of industrial development in India. These issues include impact and determinants of the FDI in selected industrial sector under the LPG framework. In order to explore the rationale and scope of further Government policy reform the study includes ownership control, inward flow of the FDI into India, sectoral trends in the FDI, channel of the FDI approvals, major the FDI suppliers and FDI flows into India and FDI in India and other Asian countries. The study also analyzes industrial development in India before and after the liberalization of Indian economy.

**Objectives of the study**

The following are the objectives of the study: i. To review the policies of the Indian Government towards the growth of the FDI. ii. To review the inflows of the FDI into India. iii. To examine the FDI and its impact on industrial performance in India. iv. To study the determinants of the FDI and its impact on Indian Economy. v. To analyze and compare the role of the FDI in India and other Asian countries.

**Research Methodology**

This study has been carried out with the help of secondary data. The required secondary data for the analyses of the study were collected from published sources. The trend and pattern of the FDI based on annual approval and the actual FDI facts were collected from the monthly bulletins of the Reserve Bank of India (RBI). The other data which include Industrial production, Industrial growth rate, GDP and its index growth rate, domestic savings, capital formation, Foreign Institutional Investment, FPI, were taken from various handbook of statistics of Indian Economy, Economic Survey, various magazines, newsletters from SIA and from daily newspapers. The data related to global FDI inflow and outflow, mergers and acquisition, developing and developed countries, and Asian countries were taken from the annual publications of World Investment Report, Asian Development Bank Report and reports from web sites of various official sources of the FDI details.

**Period of the study**

The study uses FDI data and other related data for empirical analysis covering the period between 1990-91 and 2007-08, because from 1990-91 onwards India opened its economic door for foreign investors.

**Limitations of the study**

The study is based on secondary data collected from various sources. It is very critical to apply and analyze some of the issues which is connected to this study in respect to the FDI inflow, the GDP, the Industrial development and other qualitative aspects. This study covered micro and macro aspects of the whole Indian economy and of the macroeconomic aspects of the Asian countries. Hence, it was not feasible to evaluate each and every aspect of micro macro comprises of economy.

**Conclusion**

The research study found that the FDI plays a significant role in the process of economic development of India. The Foreign Direct Investment is essential for the development of Indian economy. Indian economy has grown substantially around 8.56% in the year 2007-08. But often the FDI creates confusions like possibility of adverse effect on exports, industrial production, balance of payment, domestic savings rate, political pressures, production of basic goods and services. The role of the foreign investment during the pre independence period was to exploit the natural resources and suppress the Indian traditional business. As the colonial master, Britain with high business interests in India was the key driver of trade policies in India during this period. This study provides a road map for future research in the area of FDI and its significance in India's capital market, role of FDI in the service sectors including financial sectors, comparative study of FDI in India and rest of the developing countries, a comparative study of Indian Government policy towards FDI and other Asian countries policies and the like.

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