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FDI IN INDIA: IMPACT OF RECENT REFORMS

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General overview of FDI in global economy

FDI or Foreign Direct Investment in a perfect world is a situation where multi-national companies invest in different nations that results in consumer welfare, economic welfare, jobs creation and opportunities for recipient country and profits from investment for the host country. If history has shown anything then we can assume that in most ideal scenarios FDI has been a major driver and source of development especially in emerging markets and nations like India.

It can be reckoned from the economic history of the world that opening up of economy, liberalization and better ease of business, generally leads to a better standard of living, Economic growth and opportunities for the recipient nation. We have seen this happening in Spain, when in 1986 it joined the European Union and decided to open up its economy and later in 1999, due to increase in private consumption coupled with deregulation in the economy Spain became a leader in the world economy.

Not just Spain countries like China, Taiwan and Singapore all have benefited immensely from FDI inflow from developed nations and now themselves have become great investors in other countries. So yes from all the examples, it’s easy to understand why economist have always linked FDI with economic and consumer prosperity but huge FDI is not easy to attract. In order to attract FDI, a country must follow the policy of liberalization, avoid TRIMS barriers and facilitate easy private funding and should focus on monetization and privatization of economy.

Improving regulations, ease of doing business and having a stable economy is no walk in the park for a nation but let's go over some of the key steps that can be taken to go in this direction. First is easy and and unrestricted flow of capital in the economy by reducing trade barriers and tariffs and also a good and private financing system. Second essential is a developed, matured and effectively regulated stock market where equity can be raised and IPO's are encouraged. Third and a very essential requirement is to facilitate FDI in economy by opening up all sectors to FDI and imposition of minimum trade barriers and limitations in form of TRIMS. Fourth step would be to insure more political stability in the nation and avoidance of making frequent and quick economic policy changes. And lastly diversification of risk and opportunities in the country for investors, this is should be insured because investors investing in developing countries consider it as more of a risk than investing in a matured market.

Now these policies and liberalization never are intended to get rid of all essential regulations like a good labor policy, a robust competition commission and good law and order, because these policies are required so domestic companies are not unfairly harmed, completion in the market is healthy and monopoly is not created but these regulations should be flexible and liberal enough to facilitate good contract enforcement, robust but clear labor laws and hassle free land acquisition regulation.

How in India FDI was introduced?

FDI was introduced in India in 1991 under the (FEMA) or Foreign Exchange Management Act. It was implemented by then finance minister, Dr. Manmohan Singh. These reforms were brought to facilitate and allow international trade and investment in India in order to increase economy growth, reduce forge exchange deficit and bring international competition in the market. It started with the baseline of 1 billion dollars in 1990.

FDI doesn't just help in economy and growth but also brings new ideas, skills, innovation, new practices and improved infrastructure in the recipient country. Thanks to these initiatives and reforms India today is considered among the most significant destinations for foreign direct investment and major sectors that have witnessed a boom since then have been, IT software, telecommunications, automobiles, machinery and hardware and so on.

Before FEMA, India had FERA (Foreign exchange regulation act) which was really restrictive and failed to attract major foreign companies also the regulations were stiff and bureaucracy and red tape was high. This blocked free flow of capital and economy remained largely state controlled and underdeveloped. **Below is a brief overview of shortcoming of FERA:**

- Most offences were primal offences and turned away investors from engaging in the economy.
- Current convertibility was hard. Companies could not set up their company in their own names but had to collaborate with other Indian brands and dilute their share.

- In most sectors, companies had to take permission from RBI before investment and process was very tedious.

- Foreign Companies could not set up these branch offices or subsidiaries in India. (it was generally not allowed).

Below is a brief overview of improvements that FEMA brought in the FDI regulation in India:

- Contained provisions for no restrictions on current account transactions and also liberalized capital account transactions.

- More sectors of economy opened up automatic route for FDI.

- Arrest was made an option for exceptional cases. And mainly It did away with a lots of red tape and heavy regulations and made currency convertibility, capital flow and overall investment environment way more convenient for foreign companies.

- All these developments lead to establishment and growth of various other good regulators like SEBI, competition commission and lead to better corporate governance in India.

Types of FDI, Kinds of investment in FDI and difference between FDI and FPI.

FDI in India may be divided into many categories, like Horizontal FDI, Vertical FDI and Platform FDI. Horizontal FDI is when an international firm replicates the actives and works in the same level of value chain in the recipient country, as it has in the home country.

Vertical FDI is where the international firm may go up or down the level of value chain/market when investing in another company like Walmart in India and last but not the least Platform FDI., that means FDI from a source country into a destination country is carried out with the purpose of exporting to a third country.

In India there are mainly two methods of bringing in FDI, one is the automatic route and other is the government route. Automatic route is where a firm can invest in that sector of market without taking prior government approval but in government route, one will need government permission for investing, that is ordinarily provided by RBI. Before FEMA many of the sectors had only government route and process was very tedious but after its introduction most sectors have been opened up to automatic route and quantum of FDI allowed in the sector has also increased.

It is important to note that some sectors/industries in India have still not been opened to FDI mainly because of security and legal reasons like in atomic weapons, gambling, lottery, chit funds, railways etc. That said however, some of the sectors I think, that will greatly benefit from a more liberalized FDI cap and policy are medical sector, education sector, aviation sector, multi-brand retail sector and so on.

Table 1

Table showing sector wise FDI Equity Inflows in India

Amount in Rs. crores (US$ in million)

	Sector	2016-17	2017-18	% age to total Inflows (In terms of US$)
1	Services Sector	58214	43249	21
2	Computer Software & Hardware	24605	39670	19
3	Telecommunications	37435	39748	19
4	Trading	15721	28078	13
5	Construction (Infrastructure) Activities	12478	17571	8
6	Automobile Industry	10824	13461	6
7	Power	7473	10473	5
8	Chemicals (Other Than Fertilizers)	9397	8425	4
9	Drugs & Pharmaceuticals	5723	6502	3
10	Construction Development	703	3472	2
		182573	210649	100

(source: http://dipp.nic.in/)

Below is the list of sectors. and there performance in terms of FDI in flows in the years 2016-17 and 2017-18.

Methods of foreign direct investment in India:

The foreign direct investor may obtain voting power of an enterprise in an economy through any of the following methods:

- By the means of including a fully owned subsidiary or firm anywhere
- By obtaining shares in an associated company
- Via a merger or an acquisition of a firm that is not related
- By taking part in an equity joint venture with another investor or company

In 1997, India permitted foreign direct investment in cash and carry wholesale. This mean that any foreign investment into the country required government approval. However, in 2006, the prior approval requirement was relaxed and automatic permission was put into place.

Foreign investment in an Indian company can be done in the following ways, permitted by the Foreign Exchange Management Regulations (FEMA):

- As an integrated entity by incorporating a company under the Companies Act, 1956 through
- Joint ventures; or
- Wholly owned subsidiaries

- As an office of a foreign entity through

Parameters	FDI	FPI
Definition	FDI refers to the investment made by foreign investors to obtain a substantial interest in the enterprise located in a different country.	FPI refers to investing in the financial assets of a foreign country, such as stocks or bonds available on an exchange.
Role of investors	Active Investor	Passive Investor
Type	Direct Investment	Indirect Investment
Degree of control	High Control	Very low control
Term	Long term investment	Short term investment
Management of Projects	Efficient	Comparatively less efficient
Investment has done on	Physical assets of the foreign country	Financial assets of the foreign country
Entry and exit	Difficult	Relatively easy
Leads to	Transfer of funds, technology, and other resources to the foreign country	Capital inflows to the foreign country
Risks Involved	Stable	Volatile

- Liaison Office / Representative Office
- Project Office
- Branch Office

Difference between FPI and FDI:

To understand fully FDI we need to explore how it is different from and FPI i.e. (Foreign portfolio investment). FPI are normally seen as short term investment as compared to FDI and FPI is rather known as a small investment mainly in stock market, whereas FDI is a bigger investment and more capital oriented investment rather than current investment in areas like factories, establishing businesses and large scale takeovers or long term investment. It is very rightly said FDI carries a lasting interest and FPI signifies a weaker commitment and is not as much of a lasting interest. Below is a table showing differences between the two:

One of the more major change that was brought in recent time between FDI and FPI is in how it's differentiated. Now any holding of shares or investment of above 10% of the total shares in a listed company, will qualify as FDI. But Investors who invest less than 10% may also invest as FDI, given the condition that they acquire above 10% stake within a year of initial investment.

This impacts investors as previously Investors that needed no permission to invest under FDI for less than 10% stake will have to change their investment into FPI and that will include going through more paper work and regulations.

In 2019, there have been some key changes in FDI and FPI policies, let's take a look at them:

- Reclassification of FPIs into two categories instead of three under the 2014 Regulations.
- Existing FPIs shall be re-categorized in Category I and II FPIs by their respective DDPs.
- The requirement to satisfy the broad base condition has been eliminated.
- Entities in IFSC shall be deemed to be non-resident in India and also appropriately regulated.
- FPIs holding securities or derivatives and not a valid COR to sell securities or wind-up their open positions in derivatives within one year from the date of publication of the 2019 Regulations.
- FPIs shall be deemed to have applied for surrender of its COR, if it fails to pay the prescribed fees within the due date and does not have cash/ security/ derivative positions in India.
- Where the investment in equity shares of a company by a FPI and/ or its investor group is 10% or higher of the total paid-up equity capital on a fully diluted basis of such company, the excess holding to be divested within 5 trading days from the date of settlement, failing which the entire investment would be reclassified as FDI holdings and no further portfolio investments would be permissible in such companies.
- Off-market sale of unlisted securities received by FPIs on account of involuntary corporate actions permitted.
- Off-market purchase/ sale of illiquid, suspended or delisted securities by FPIs permitted.
- ODIs can be issued only by/ to Category I FPIs.

Recent reforms and increase in FDI in India and impact it may have

FDI policy has changed in a big way in recent years. The recent reforms have been directed to solve the issue of low FDI caps across sectors and lack of focus on reduction of non-tariff barriers. Nations in south east Asia like Singapore, Taiwan and Thailand have been historically much more successful in attracting foreign firms, because of their more liberal policies, easy labor laws and relatively less paper work.

That's why in many sectors FDI cap has been increased for example in Defense sector where government wants that more foreign companies come and invest, FDI limit has been raised to 49% from 26%. Similarly, in Pharmaceutical industries FDI limit in 2014 was increased to 74%. And in many more sectors, FDI has now been allowed up to 100% like medical devices, Insurance intermediaries, coal mining, Railways, Single brand retail trading etc.

Also in order to give access to International firms to invest in recent IPO (initial public offering) of LIC, there has been a change in the the definition of "Indian Company" to include a body corporate or company incorporated in India. Government has now also clarified that mergers, demergers and amalgamation of Indian Companies with international companies will not require a permission when it is under any automatic route sector.

Government has also attempted to engage in consultations with stakeholders and industries to facilitate more FDI and thanks to all of this FDI did touch up to $500 Billion dollars in the year 2020. Which is still far less than China's 1.14 trillion in the same year and is far from full potential of India but can definitely be recognized as steps in the right direction.

In a retaliatory move after India's clashes on border with china, in 2020, India Introduced a blanket ban on automatic route FDI from all the countries it shares borders with. This decision I believe was made under the influence of the clashes on the border and doesn't actually reflect any backtrack of the government from its current FDI policy that is to attract more of it.

But what is keeping India from its full potential, let's go over some of the problems I think India still faces -

1. Protectionist and erratic polices –Government, no wonder is going hard and is progressive on FDI rules but still fears full opening up of economy as it is scared that local industry might not be able to compete but this mentality has to go and India has to allow FDI so that local firms can compete and adopt global standard in product and service production.

2. Lobbying from local firms - Lobbying from local players keep the government from reducing import duty and from allowing certain companies and sectors like multi brand retail from having access to investment in India and as a result consumers suffer and standard of living does not go up the way its expected.

3. High tariffs - Government protectionist policies and revenue requirements pushes it to levy high tariffs especially as seen in automobile and some other industries that keeps that particular industry from reaching its full potential.

4. Law enforcement problem - Vague labor laws, burdensome land acquisition process and lack of quick and effective contract enforcement policy keeps India from tapping into huge amounts of FDI

5. Developing nation - And last but not the least as people in India have relatively lower purchasing power, have a very diverse and unique culture and relatively less developed infrastructure, investing in India is still seen by companies as huge risk.

Despite these drawbacks, there have been some positive news on the front of international trade. India, has successfully signed a long sort after Free trade agreement with Australia in 2022 and with United Arab Emirates also in 2022. This shows that India is accelerating towards a freer trade environment and in the rumors is also a potential UK-India free trade agreement. These agreements basically allow a much easier, paper work free and less restrictive flow of goods and services between the nations.

Insurance and health sectors have also been pushed by the government to attract more FDI and foreign investment. The recent initiative by Indian government of "Self Reliant India" is not to be confused with a restrictive policy but I believe is a policy to actually promote exports, Increase make in India (Through foreign investment) and diversification of risk in supply chain.

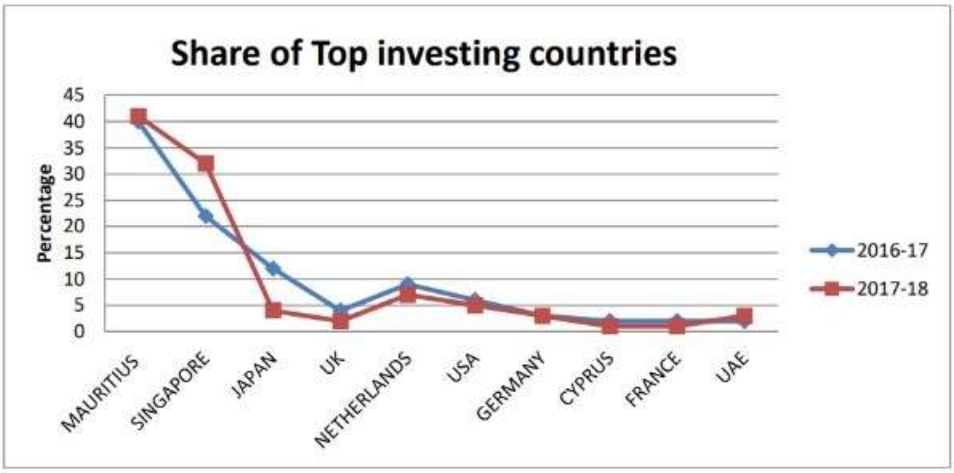
And if one thing, the current pandemic and wars have taught us, it's that we should not rely on a single source or a country for raw materials or supply, rather we must try to diversify the logistics chain, distribute our risk and stop reliance on a single nation for example china for most of our essential products.

I do believe FDI and free trade is the glue the holds the modern world together, forces nations to have friendly relations and keep the consumers that are the people, happy and rightly served. Now let's go over some the changes the new rules like free trade agreement and increase in FDI caps may have on our economy -

- Long term growth in economy - FDI brings long term growth and stability in a developing economy. It makes people and companies more skilled, competitive and forces global standard. MNCs bring technology transfer to domestic companies and that results in more innovation and industrialization and employment level also rises. So more of FDI and trade will only accelerate this phenomenon.
- Strong output and productivity - FDI strengthens balance sheets and it raises assets of the companies. Per capital income increase as consumption increases and GDP witnesses a growth. And because of these polices, output and productivity in the economy, I believe, will see this impact in long term.
- Highest rate of return - Free flow of capital and free trade agreement will definitely allow MNCs and international firms to go for the highest rate of return and use their resources in most sustainable and efficient way.
- Increase in exports - More FDI from foreign investors will mean more innovation, more competition and adherence to global standards, that will push domestic manufacturers to perform their best and produce better products and export them successfully. According to Mundell Fleming model in an open economy, Bond prices go up, interest rates go down and investment escalates further.

That's why it has become increasingly important in today's world to attract more foreign investment and allow free trade of goods and services along with reduction TRIMS barriers. This will surely put India to a quick path to success.

Here is chart showing different nations' share of contribution in FDI in India.



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Conclusion

This article went through explanation of Foreign direct investment, Benefits of Foreign direct investment and new reforms and impact of Foreign Direct Investment. This article is based on secondary research and shows data of different sectors and countries' role in FDI, over time in India. Countries like Mauritius and Singapore have been the leading source of FDI in India.

I also predict rather optimistically that these new reforms that intend to liberalize FDI regulations will, (if they work how they are meant to), show an increase in investment in India. As a conclusion we can say that it remains to be seen how these new reforms in FDI, will impact the Indian economy and if India is able to resolve some of the roadblocks in its FDI policy.

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