

Foreign Direct Investment (FDI) and Indian Economic Growth: An Analytical Study

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Abstract: Foreign direct investment (FDI) is widely regarded as an essential driver of economic growth. There is a large body of scientific research focusing on many aspects of the relationship between FDI and economic growth, particularly in transition nations. FDI flows into India have increased quickly since the policy system was liberalised in the early 1990s. Nonetheless, when calculated as a percentage of GDP or overall investment, they remain tiny. In other words, they play a relatively minor influence in the growth of our economy. This stands in stark contrast to the critical role that FDI has played in the economic development of other rapidly rising Asian economies such as ASEAN and China. Over the last two or three decades, what has come to be known as the “FDI-Export” paradigm has fueled the rapid growth rates of Singapore, Thailand, Malaysia, Indonesia, and China. The reason for India's very low FDI rate in comparison to comparable countries is due to both external and internal factors. On the one hand, the prevalent literature body emphasises the importance of FDI as a significant source of scaling up production, efficiency, growth, and management know-how, whereas another group of researchers has criticised the inflow of FDIs into the Indian economy and expressed their concerns about its negative effects, referring to them as weapons of economic exploitation of developing countries. As a result, it is critical to examine the influence of FDIs in the growth of the Indian economy. The impact of FDI on the economy may be divided into two categories: direct and indirect. In terms of direct impact, FDI inflows have a considerable impact on levels of domestic income, employment, price level, productivity, efficiency, and export growth. The spillover effects of FDI can account for the indirect influence of FDI. The unique benefits of FDI, particularly the types of incentives granted to foreign enterprises in practise, have begun to be called into question. The empirical evidence for FDI generating positive spillovers for host nations is equivocal at both the micro and macro levels, fueling this dispute. Spillovers from FDI account for the impact of foreign players entering a competitive domestic market, resulting in higher productivity, quality, and other business processes.

Over the previous two decades, the Indian economy has received a significant amount of FDI in a variety of sectors. The majority of FDI inflows, however, can be found in the services sector, which accounts for roughly one-fifth of total FDI inflows. Construction, automobiles, infrastructure, telecommunications, pharmaceuticals, chemicals, and power are among the other industries that have seen considerable FDI inflows. The study's goal is to investigate the impact of FDI inflows on India's services, construction, trading, mining, and agricultural sectors.

I. Introduction

The history of foreign direct investment in India may be traced back to the creation of the East India Company of Britain. During Britain's colonial era in India, British capital came to India. After WWII, Japanese firms entered the Indian market and increased their trade with India, but the United Kingdom (U.K.) remained the most prominent investor in India. Furthermore, following independence, policymakers focused on concerns connected to foreign finance and MNC operations. Policymakers developed the FDI policy with national interests in mind, with the goal of using FDI as a channel for acquiring sophisticated technology and mobilising foreign exchange resources. Changes in FDI policy have occurred over time and in accordance with economic and political environments. The possible benefits of FDI on the host economy include the facilitation of the utilisation and exploitation of local raw materials as well as the introduction of contemporary management and marketing skills. Better quality goods and services are made available to domestic customers as a result of FDI investments. The 1965 industrial policy permitted MNCs to penetrate into India through technological partnership. Following that, the government took a more liberal stance, allowing for more regular equity investment. During a critical period in the Indian economy, the government of India implemented a macroeconomic stabilisation and structural adjustment programme with the assistance of the World Bank and the IMF. As a result of these reforms, India opened its borders to FDI inflows and developed a more flexible foreign policy in order to regain foreign investors' trust. Furthermore, as part of the new foreign investment strategy, the Government of India established the FIPB (International Investment Promotion Board), the primary aim of which was to invite and facilitate foreign investment. A recent UNCTAD survey forecast India as the second most important FDI destination (behind China) for transnational firms during 2010-2012, starting from a baseline of less than USD 1 billion in 1990. According to the data, the sectors with the highest inflows were services, telecommunications, construction activities, and computer software and hardware. Mauritius, Singapore, the United States, and the United Kingdom were among the largest providers of FDI to the country.

According to GYANPRATHA – ACCMAN (Journal of Management, Volume 5 Issue 1, 2013) FDI for 2009-10 at US\$ 25.88 billion was lower by five per cent from US\$ 27.33 billion in the previous fiscal. In 2013, the government reduced FDI rules in various industries, including telecommunications, defence, public-sector oil refineries, power exchanges, and stock exchanges, among others. The role of FDI in the global economy has grown substantially during the last 15 years. The overall

stock of FDI climbed from 8% of global GDP in 1990 to 26% in 2006. Although the majority of FDI continues to flow between OECD nations, the increase in FDI has been particularly pronounced in developing countries, owing largely to the integration of large rising economies, known as the BRICs (Brazil, Russia, India, and China), into the global economy. FDI into underdeveloped countries has increased dramatically. Non-OECD nations' share of global inward FDI has increased from 22 percent in 1990 to 32 percent in 2005. China is by far the most major non-OECD recipient of FDI, accounting for almost one-third of non-OECD FDI in 2005. However, FDI inflows are also significant in many other rising markets. Indeed, since the mid-1990s, inward FDI has become the primary source of foreign funding for developing nations, accounting for more than twice the amount of government development aid.

The following is the study's major goal: To investigate the impact of FDI inflows on India's services, construction, and trading, mining, and agricultural sectors.

II. Review of Literature

“Debatable views of spillovers in technology, knowledge, productivity and creation of competitive business scenario coupled with a growth in capital inflow triggered by FDIs has been well documented in the literature. Some critics however view that FDIs could bring about deterioration in the balance of payments in developing countries like India

(**Kaur, Yadav &Gautam, 2013**)¹. The causality between FDI inflow and economic growth also spurs in considerable contradictory opinions in literature. In this section, we highlight in brief the contradictory viewpoints about this linkage and try to identify other parameter which determines FDI influx in developing countries. The relationship between the inflow of FDI and economic growth in developing countries like India is documented in literature with contrasting viewpoints. The beneficial effects of FDI on the economic growth mainly arising due the spillover effects has been empirically analysed by **Borensztein, De Gregorio and Lee (1998)**²; **Zhang (2001)**³; **Sun and Parikh (2001)**⁴; **Liu et al. (1997)**⁵; **Tsai (1991)**⁶; **Hansen and Rand (2005)**⁷; **Yao (2006)**⁸; and **Chang (2007)**⁹. Another group of researchers had tried to establish the linkage between FDI and economic growth. Although there are very limited evidences in literature addressing the issue to that context, it has been an area of interest to the researchers recently. However, the studies have reported contrasting results about the nexus between FDI and Economic growth (**Choi and Baek, 2017**)¹⁰; **Chakraborty and Basu, 2002**¹¹; **Agrawal and Khan, 2011**¹²; and **Dash and Parida, 2013**¹³; **Sahoo and Mathiyazhagan, 2003**¹⁴; **Pradhan, 2002**)¹⁵. According to **Pradhan (2002)**¹⁵ FDI does not have significant positive growth impacts and thus they have concluded that the contribution of FDI to economic growth was minimal. On the other hand, **Chakraborty and Nunnenkamp (2008)**¹⁶ find that the influx of FDI contributes to economic growth for the Indian economy. **Dash and Parida (2013)**¹³ reported about passing a beneficial effect of FDI on growth, after controlling for trade.

The results were however not contrasting only to the context of India. The available literature also documents for cross country studies and documents for this contrasting results. Johnson (2006) examined the impact of FDI on growth for a panel of 90 countries and found the result to be positive and significant. While **Motaleb (2007)**¹⁷ assessed the impact of FDI on growth for 60 low and middle income countries and concluded that large GDP and GDP growth rate are instrumental in attracting FDI Some researchers view FDI as an instrument for promoting the economic growth of host countries. **Balasubramanyam et al. (1996)**¹⁸ shows that FDI leads to growth in those countries which followed export promotion policies over import substitution policies.

Apart from these parameters of balance of payments, trade and growth, few other factors also contributed to the inflow of FDI. These factors include human capital, GDP per capita, government consumption, foreign exchange and trade distortions (**Siddiqui and Ahmed, 2017**)¹⁹, **Borensztein et al., 1998**)²⁰. Other factors like stable macroeconomic policies, institutional quality, lowering inflation rate, tax rates, and government consumption are required to attract FDI and lead to growth (**Siddiqui and Ahmed, 2017**)¹⁹. **Dhakar et al. (2007)**²¹ indicate that in India causality is bidirectional and flows from growth to FDI and from FDI to growth. Trade openness and development of the financial sector are also desired for attracting higher FDI in India. **Mathiyazhagan (2005)**²² examines the relationship between FDI, output, export and labour productivity for the Indian economy during the time period from 1990-1991 to 2000-2001 based on the model given by **Sahoo et al. (2002)**²³ and **Sahoo and Mathiyazhagan (2003)**²⁴. It is found that FDI has led to a rise in output, labour productivity and export in a few sectors which is not highly significant. It has also been suggested in the study to open up export oriented sectors in order to achieve higher growth of the economy through these sectors. Education level of the labour force also plays significant role in determining the FDI influx to a country (**Siddiqui and Ahmed, 2017**)¹⁹. “Based on this literature review, it is prudent to say that the causality of the FDI and economic growth needs to be established. Further, it is also necessary to identify the other parameters via empirical methods which have an impact on the FDI influx in India.”

III. Details of FDI

The research relies on secondary data. Secondary data were gathered from the websites of the Department of Industrial Policy and Promotion, Ministry of Commerce and Industry, Government of India; the Reserve Bank of India (RBI); the World Bank, and the online data source CMIE. The study spans the years 2007 to 2017. The research covers five industries: services, construction, trading, mining, and agriculture. The two well-known strategies for estimating panel data are the Fixed Effects (FE) model and the Random Effects (RE) model. The former makes it easier to investigate the relationship between predictor and outcome variables inside individual entities. The fundamental assumption of FE is that some qualities within the individual can introduce bias or influence the outcome variables. The FE model, which is based on the assumption of a correlation between the entity's error term and predictor factors, aids in controlling this effect. The FE model allows us to evaluate the net effect of the prediction by eliminating the effect of those time-invariant characteristics from the predictor variables. We would base our model selection on the Hausman Test. The study used the Panel Regression Model and the STATA programme.

IV. Results

Firstly, we have run Random Effect Panel Regression Model and the outcomes are given below.

Sector GDP	Coefficient	Standard Error (SE)	z statistic	P Value
Sector FDI	0.012	0.004	4.93	0.000
Constant	5815.574	2425.755	2.41	0.017
R Square	0.325			
Chi Square	24.260			
Prob. >Chi Square	0.000			

Table 1: Random Effect Panel Regression Model

After Random Effect Model, we have run the Fixed Effect Panel Regression Model and the results are given below.

Sector GDP	Coefficient	Standard Error (SE)	t statistic	P Value
Sector FDI	0.012	0.003	4.85	0.000
Constant	5814.816	358.360	16.24	0.000
R Square	0.324			
F Statistic	23.49			
Prob. > F	0.000			

Table 2: Fixed Effect Panel Regression Model

To select the effective model for this case, we have done Hausman Test between the Random Effect and Fixed Effect and the result of the same is given below. Test: Ho: difference in coefficients not systematic

$$\begin{aligned} \text{Chi Square} &= (b-B)'[(V_b-V_B)^{-1}](b-B) = 0.00 \\ \text{Prob}>\text{chi}^2 &= 0.9964 \end{aligned}$$

The Hausman Test results indicate that we should reject the Fixed Effect Model and choose the Random Effect Model at a 5% level of significance.

The Random Effect Model results show that the impact of sectoral FDI is positive, which suggests that as FDI inflows increase, so will the growth of that industry.

V. Conclusions

The analysis concludes that FDI inflows have a favourable influence on GDP. This would be useful for policymakers in developing strategies to target GDP based on FDI inflows. This research needs to be expanded to include other control variables that affect GDP. This model reflects the overall impact of FDI on GDP; however, the sectoral impact must be examined further before any conclusions can be drawn.

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