

# Chapter- I



## INTRODUCTION

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## 1.1 Background of the study

The term ‘foreign investment’ historically bears lots of suspicion, fears and distrust among Indians since the days of British colonialism and imperialism in the country. In the world history, very few economies have experienced of being so brutally exploited and looted as India unfortunately has been, by a so called group of overseas merchants. The atrocity and economic massacre in the form of phased exploitation turned India from one of the richest countries in the world luring everybody by its wealth and prosperity to one of the poorest countries till almost the end of the nineteenth century (Jha, 2014). With this panic memories, unlike most of the other economies in the world, the policy makers of the country always go with suspension and caution that the depredation of empire resources in the name of foreign trading or investment must not repeat in Indian economic history. Besides, India by its very tradition went with the *swadeshi* ideology that means national economic self-reliance (Wolf and Houseman, 1997; Charlton, 1997). In fact the present Make in India campaign is the clear projection of India’s so called *swadeshi* ideology infused long before during end of the nineteenth century by some of the Indian great political and social leaders like Dadabhai Naoroji, Gopal Krishna Gokhale etc. It is the very *swadeshi* spirit which made Indian policy makers keep the economy closed and dormant till mid-eighties of twentieth century. Unfortunately till then, slow economic growth and rapidly increasing current account deficit (CAD) had become a serious malaise for the economy.

According to the World Development Report, while average annual economic growth rate of the Four Tigers, adopting export-led growth strategy, was at 9.5 percent during the period of 1963-73, it was only 4.1 percent in the countries which followed the import-substitution industrialization (ISI) strategy. With the same ISI strategy India has also witnessed an average economic growth of only around 3.5 per cent (famously known as the Hindu growth rate) from 1950s to 1980s. In fact, at the time the approach to solve economic crisis was still inwards and efforts were on to solve this (CAD crisis) with India's own 'resources and ingenuity' (Economic Survey 1991-1992. New Delhi: Ministry of Finance & Company Affairs, Government of India). Of late, the country begun to realize the impact of adopting free market and outward oriented trade policies by looking at the remarkable growth attained by the East Asian tigers those become independent concurrently with India. The neo-classical economists also begun to rely on the doctrine of export-led growth mainly by witnessing the economic success achieved by the East Asian Tigers (World Bank, 1993). Notably, the Indian policy makers have learnt a lesson on how these economies have utilized the necessary infrastructure and international linkage developed by colonial government (Gulati, 1992) in operationalizing their export-oriented industrialization strategy. In the subsequent period, India by gradually liberalizing various trading barriers and accepting the idea of export led economic growth managed to attain an average annual growth rate of around 5 per cent for the period of 1981 to 1991. Concurrently, the development economists and academicians worldwide for example Feder, 1982; Helpman and Trajtenberg 1987; Krueger, 1990 have highly accepted the export-led economic growth hypothesis.

However, despite profound effects on the economic growth and foreign trading status witnessed by other emerging and emerged economies, the concept of FDI-led

economic growth had still remained ambiguous and vexing for the Indian policy makers until 1993-94. Although, *swadeshi* spirit approves domestic competition and even embraces free trading but foreign investment still remains a question (Jhunjhunwala, 2002). Therefore, for the Indian government the inward-FDI liberalization was more a strong challenge than foreign trade liberalization. The Swadeshi Jagaran Manch (SJM) organised by the Rastriya Seva Sangh (RSS) in the November 1991 has claimed it to be *anti-swadeshi* move and a new form of western imperialism (Singh, 2005). Honestly speaking the political ideologies of two major political parties of India (Bharatiya Janata Party and the Indian National Congress) are even for long at odds based on their perception towards *swadeshi* ideas. Again, the trade policies of Indian economy during different government regime by and large guided by the *swadeshi* idea and always contain ambiguities due to various economic and political pressures (Wolf and Houseman, 1997). Consequently, it has taken long time for the policy makers to reach the consensus on the importance of liberalized foreign investment policies for the economic wellbeing by reducing the mountain current account deficit and that it would not hurt the *swadeshi* spirit of the nation. As of now, economic growth through free trading and allowing inward foreign investment has become an integral part of India's national economic policy.

Savings and investments are the two powerful arrows which shape the institution of an economy by determining its overall production and operational capacity and self sufficiency in producing goods and services, ensuring large amount of productive employment, defining the nature and quality of capital goods a country hold and thereby play an important role in accelerating overall economic growth (Anderson, 1990) and sustainability of any country. Both Neo-classical and Marxist economists have considered investment and capital formation to be the engine of economic

growth of a nation. The existence of a savings-investment-economic growth trilogy has also been a familiar view in many countries (Raheem and Oyinlola, 2017). More often than not, in emerging economies there always exist a savings-investment gap (Adom and Elbahnasawy, 2014; Ganioglu and Yalcin, 2015) and can many times seen to be bridged by taking loans from international financial institutions (e.g. International Monetary Fund, International Bank for Reconstruction and Development, Asian Development Bank etc) and foreign banks, portfolio investment by foreign institutional investors and mostly through allowing and promoting foreign direct investment. However, among all sources of external finance, the flow of fund through allowing FDI is generally proved to be most effective and beneficial for a country because of its features like non-debt creating source of finance, contribution to home country's production (Gunaydin and Tatoglu, 2005), generation of additional employment and income (Wong and Tang, 2011), promotion of export (Jana et al., 2017) etc. FDI is a fund flow between two countries by which source country can benefit from their investment out of free market accessibility whereas host countries can take this opportunity to enhance the productivity (Li et al., 2001) and increase the financial resources through diffusion of technological know-how (Barrell and Pain, 1997), expertise managerial and entrepreneurial skills, expansion, diversification and sophistication of products and production process. Therefore, FDI provides a “win-win” situation to promote growth to both the ‘investing country’ and ‘host country’. Developing countries like India generally opt for a large amount of foreign investments to accelerate growth process as they often face drought of domestic investments.

However, the nexus between FDI and economic growth has remained vexing and inconclusive in the history of pre- and post-liberalization literature of development

economics. Although, the endogenous growth theory, one of the earliest theories in this regard, prophesies a positive FDI to economic growth relationship, this theoretical postulation hasn't always been coincided by empirical outcomes. Practically, FDI-growth relationship can't be generalized mainly because it is highly subject to alteration with changing institutional, policy and regulatory environment (Herzer et al. 2008). Notably, of late, the development economists from emerging and emerged economies have begun to realise another crucial cause of heterogeneity in findings across economies; i.e., the sectoral composition of inward-FDI. Subsequent studies commonly highlight that the sector wise decomposed FDI has a bearing on the impact it would exert on the economic growth process (Hirschman, 1958; Borensztein et al., 1998; Alfaro, 2003). According to these studies, FDI can't be supposed to exert equal economic influences in all the sectors of an economy. This is because, these sectors are substantially different from each other in many aspects including government policies for each sector, their capacity to absorb investments, technology base, human capital involvement, legal and institutional framework etc. (Borensztein et al., 1998; and Li and Liu, 2005). According to Hirschman (1958), not all sectors have the equal potential to absorb foreign capital and technology or to create linkages with the rest of the economy. Borensztein et al. (1998) and Li and Liu (2005) again endorse the interaction of human capital and technology base of the host country with the dynamics of FDI and economic growth. According to them, FDI, only when supplemented by human capital, exerts a favorable impact on economic growth in developing countries, while that of FDI with the technology gap has a significant negative impact. Therefore, there are obvious reasons as to why the effect of FDI can vary with sectoral or even industry specification (Chakraborty and Nunnenkamp, 2008). In this point, it is noteworthy that the economic literature on total FDI to

aggregate growth relationship were based on a tenuous assumption that FDI in different sector would exert equal impact on the economic growth (Wang, 2009) and they are of homogeneous characteristics. Thus, a more stringent analysis of this relationship requires appropriate treatment of FDI before linking it with economic growth.

Coming to the context of India, as per the recently available data on Indian economy (Source: Sector-wise contribution of GDP of India, StatisticsTimes.com, Retrieved 22.04 2018), primary sector accounts for only 17.32 percent of Gross Value Added (GVA) of the country's economy. The secondary sector of the economy represents the manufacturing sector and its contribution to the GVA of the country is 29.02 percent. The service sector is the largest sector of Indian economy and the sector accounts for 53.66 percent of India's GVA.

Besides sectoral contribution to national output, unlike other emerging economies, another notable point of cross-sectoral difference of Indian economy lies in their potential to create spill-over effect and the ability to form intra-sectoral and inter-sectoral linkage within the economy. According to World Investment Report 2001 (UNCTAD), in an economy the linkage potential differs across sectors and it is found to be the highest in the case of service sector followed by manufacturing and primary sector. In the same way, among the three sectors of Indian economy, the primary sector has the least linkage and spill-over potential with rest of the economy due to its feeble infrastructure, poor technology base, conventional operations, less commercialization of output and diversification of activities etc. The growth of primary sector, unlike other two sectors, is also extremely volatile which is largely due to its high natural dependency like degree of rainfall, temperature, natural hazards etc. Contrary to the primary sector, the FDI in manufacturing and especially service

sector has greater potential to generate favorable impact on the growth of the respective sectors due to better defined linkage and opportunity of spill-over. Unlike the other two sectors where output is exportable, services by its nature require close proximity between producers and consumers and are limitedly tradable. However, in India the sector has immense potential to create positive impact from inward FDI.

Therefore, high cross-sectoral versatility in the economic activity, varied contribution towards growth and heterogeneity in individual characteristics require specific treatment for each sector while correlating with FDI (Aykut and Sayek, 2007). In India, where FDI-economic growth nexus has been examined several times by different scholars (Kaur et al., 2013; Gupta and Garg, 2015; Sahu and Pandey, 2018), to our knowledge, very limited effort has been undertaken to make a sector specific analysis. Besides, the sectoral differences in terms of economic contribution, linkage and spillover potential, dependency on external factors etc. are larger in the case of Indian economy than in most of the other emerging economies. Thus, it is worthwhile to examine the sector specific FDI-growth relationship of a country like India where each sector possesses distinct characteristics and thereby substantially different potentials to generate impact from the inward investment in the form of FDI. In this contest this study examines as to how sector-wise FDI inflows can affect the growth of respective sectors rather than the overall growth of the economy.

In nutshell, unlike most of the emerged and emerging market economies the perception towards FDI-led economic growth reasonably remains susceptible for India. This might be the reason why economic policies of India pertaining to FDI never be smooth. Lack of confidence, suspicion and great caution always prevail amongst the development economists and policy makers over the actual impact of FDI on the Indian economy. Therefore, we think it is much more interesting for the



economic scholars to inquire the nexus between foreign investment and economic growth of India than many other emerging market economies.

## **1.2 Motivation of the Study**

Theoretically, foreign investment plays an important role in propelling economic growth through multiplier and spill-over effects for both developing and developed economies. In India these external investment comes in two broad forms, namely FDI and FPI. FPI, individually the most volatile form of foreign capital, collectively it provides huge liquidity in the Indian capital market. No doubt, the recent enlarged size of Indian secondary market is the aftermath of FPI policy liberalization. But is there any positive impact of the mountain flows of FPI to economic growth? If it has what are the short-run and long-run dynamics of this flow? In comparing the binary flows of foreign investment, FDI is considered as most sustainable form of foreign capital, put its long hand in the economic growth through the branch of fragrant flowers with stiff thorns. Since 1991 India has witnessed an unprecedented growth in the volume of inbound FDI inflows that revitalized the debate about its costs-benefits investigation in order to allure more FDI inflows based on the hypothecation that inbound FDI into India is an exigent stimulus for propelling economic growth. If the assumption is true i.e. FDI inflows has an important role in accelerating economic growth, then it has another scope of analysis that whether different sectoral composition of FDI inflows matters while contributing to the economic growth of India or output growth of the basic three economic sectors magnetize FDI inflows to this country.

### **1.3 Objectives of the Study**

In order to better understand the complex and dynamic relationship between foreign investment and economic growth the study decomposes the primary objectives into macro level analysis as well as sector level analysis. On that basis, the study finally sets the following objectives to better infer this relationship:

- i) To find out the impact of foreign investment inflow on Indian economic development measured by Gross Domestic Product (GDP).
- ii) To estimate the role of investment by Foreign Institutional Investors (FII) on the development of Indian economy.
- iii) To measure the affect of inward Foreign Direct Investment (FDI) on the on the economic development of India.
- iv) To investigate the impact of Sector wise Foreign Direct Investment (FDI) inflows on volume of the respective sectors output contribution in GDP of Indian economy.

### **1.4 Hypotheses of the Study**

Keeping in mind the above mentioned objectives of the study, we have formulated the following hypotheses, which will be tested by applying appropriate statistical and econometric tests.

#### **Hypothesis – I:**

**Null Hypothesis (H<sub>0</sub>):** Foreign Investments do not have any significant impact on  
Economic development of India.

**Alternative Hypothesis (H<sub>1</sub>):** H<sub>0</sub> is not true.

**Hypothesis – II:**

**Null Hypothesis (H<sub>0</sub>):** FII do not have any significant impact on development of Indian Economy.

**Alternative Hypothesis (H<sub>1</sub>):** H<sub>0</sub> is not true.

**Hypothesis – III:**

**Null Hypothesis (H<sub>0</sub>):** FDI do not have any significant impact on growth of Indian economy.

**Alternative Hypothesis (H<sub>1</sub>):** H<sub>0</sub> is not true.

**Hypothesis – IV:**

**Null Hypothesis (H<sub>0</sub>):** Sectoral FDI do not have any significant impact on Sectoral Contribution to GDP.

The null Hypothesis can be decomposed or sub-divided as follows:

**Hypothesis – IV(A):** FDI into agriculture sector do not have any significant impact on agriculture sector's output contribution to GDP.

**Hypothesis – IV(B):** FDI into manufacturing sector do not have any significant impact on output growth of manufacturing sector in India.

**Hypothesis – IV(C):** FDI into the service sector do not have any significant impact on service sector's output contribution to GDP in India.

**Alternative Hypothesis (H<sub>1</sub>):** H<sub>0</sub>s are not true.

## **1.5 Scope of the Study**

A number of studies have been conducted earlier to explain the role of foreign investment, behavior and pattern of it, impact of various forms of foreign investment on economic growth and development in different developed and developing countries including India. Unlike most of the emerged and emerging market economies, the perception towards foreign investment-led economic development reasonably remains suspective for India. Therefore, the relationship in Indian context remains one of the challenging issues before the foreign firms, portfolio and institutional managers, lawmakers, and academicians. So there is always a scope for further study in these dynamic macroeconomic interactions.

The Indian economy has opened up considerably so as to allow every foreign investor to capitalize their funds in the large Indian unexplored market, and Indian investors are also allowed to invest abroad. Outmost liberalization and globalization of the economy ensure more choice to the foreign firms in making their investment decisions and conversely, domestic policymakers have to bargain with the foreign investors on different development issues. From both the host and home countries' perspective we find it importat to analyze the impact of foreign investment on Indian economic development in details.

This study focuses on the analysis of the impact of the inflow of foreign investment on economic development in India on the basis of macro level as well as sector level studies, step by step, for the time horizon of eighty-four quarters starting from first quarter of 1996 to third quarter of 2016. This empirical research is first of its kind in India which makes an endeavour to device the distinguish impact of sector-wise

decomposed FDI inflows on the growth of three of its sectors, namely, primary, secondary and the service sectors.

The period under study is significant as it includes changing government policies on foreign investments in India that range from being highly restrictive to becoming liberalized and less restrictive. In other words, there has been noticed a major policy shift from close-cum-dormant to open-cum-adoptive policy as we all know, beginning from the early 1990s.

This study is expected to offer some insights into the behaviour of foreign investors as well as policymakers of both the investing and recipient countries. The ultimate goal of the foreign investors is to reap maximum benefits from their investment and to ensure promotion of economic growth and development of the recipient country, i.e., India, given a favourable environment of commensurate Indian government policies in this regard. The study is, therefore, conducted at both the macro- and sector levels to fulfill these objectives using various time-varying parametric regression models.

Furthermore, the study is expected to offer some opportunities for the Indian lawmakers to formulate and implement an appropriate mix of fiscal, legal, and regulatory reforms in order to enhance the output of agriculture, manufacturing and service sectors and, thereby, ensure overall development. With the appropriate economic and country-specific reforms, India might be able to exploit the full potential of inward cross border capitals in the country's efforts to foster economic development that would bring about social change through the employment generation, cultural exchange, incorporation of innovative technology and improvement in the standard of living.

## **1.6 Outline of the Study**

This study is divided into six chapters. The first chapter looks at the background of the study followed by motivation of the study. This chapter also formulates the research hypothesis that would be tested to get answers reflected in the organized objectives. This chapter also includes the scope of the study.

The second chapter discusses the theoretical concepts of foreign investment and the FDI, FII, etc., the major components of it. This chapter mainly focuses the facts and figures relating the foreign investment and growth on and from the inauguration of liberalization policy to contemporary India.

The third chapter reviews the related literature highlighting the earlier research work of Indian as well as world context. Through the perusal review of a large set of existing literature, the research gap has been identified.

Forth chapter outlines a detail description of data, detailing the sources and study periods. This part also gives an overview of the sample design, employed statistical and econometric technique and scheme of investigation or the model specification provides the necessary comprehension of the study.

The fifth chapter diverges the analysis objective wise and reported the findings of the investigation. The sixth chapter finally converges the findings in summary and conclusion along with some policy prescriptions and scope of future study. At the end of the study, conventionally, bibliographic references have been disclosed alphabetically according to the surname of the author.