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FDI and FII as Drivers of Growth for Indian Economy: A Comparison

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Abstract:

Investment plays an important role in accelerating economic growth of any economy. Indian economy opened up to the global world in 1991 by allowing foreign investors to make investments in India. The foreign investments can be made either in the listed companies through financial markets (called Foreign Institutional Investors) or by directly investing capital in the listed/unlisted companies in India (called Foreign Direct Investment). Foreign investment complements the domestic investments by increasing economic activities and capital formation, thus bringing with it new technology advance, making the domestic market more competitive. Foreign institutional Investors (FIIs) only aid the domestic investment by increasing capital inflows through the secondary markets and are very volatile. Foreign Direct Investment (FDI) plays more important role than FIIS in progress of any developing country especially like India. India has been projected as the second most important FDI destination after China for transnational corporations during 2010-12. FDI provides not only inflow of foreign funds and investments but also transfer of advanced technology and skills, thus creating job opportunities. Although both types of foreign investments provide an impetus for economic and industrial expansion, however India should focus more on attracting FDI as it stays for longer period, for its exist policy is not as easy as for FIIs. Availability of highly qualified human resource, huge untapped potential domestic markets, low-cost manufacturing, makes India a favorable destination for foreign investors. The present paper tries to do a comparative analysis of FDI and FII and their contribution towards economic growth. For the data and methodology, the time series analysis is applied on the time period from 2000 to 2012.

1. Introduction

Till 1991 India was more or less a closed and protected economy where foreign capital was allowed only with large number of permissions and only under special cases and it was the “License Raj” that prevailed. After India got independence in 1947, there was a huge challenge in front of the government to undo the negative effect of the colonial rule. The Indian economy pursued an inward looking development strategy, post-independence, in formulating economic policies which lead in implementing a policy of import substitution, state intervention in industrialization; a larger role of the public sector in uplifting the economy was placed. It was the balance of payment crisis of the 1990s that forced India to accept the IMF's condition of opening up the economy and start a series of structural reforms. This made India an attractive destination for foreign capital. The Indian government differentiates cross-border capital inflows into various categories like foreign direct investment (FDI), foreign institutional investment (FII), non-resident Indian (NRI) and persons of Indian origin (PIO) investment. Foreign capital is preferred to bridge the gap between domestic savings and investment requirements of a country. The two most important sources through which India receives foreign capital are Foreign Direct Investment, FDI and Foreign Institutional Investor, FII. The dividing line between the two being stake that they have in the company in which they make the investment and the motive behind the same. The main difference is that the one flowing into the stock market is FII and the other flowing into the primary market is FDI. Moreover, FDI brings not just capital but also better management and governance practices and, often, technology transfer. The know-how, thus transferred along with FDI is often more crucial than the capital per se. No such benefit accrues in the case of FII inflows, although the search by FIIs for credible investment options has tended to improve accounting and governance practices among listed Indian companies. FDI and FII thus have become instruments of international economic integration and stimulation. FIIs are considered as hot money by many as they are not the stable source of capital. FDI helps creates a more competitive business environment, brings in new and cleaner technology and improves the environment and social conditions in a country. India's foreign investment policies are being liberalized in phases which are making it attractive for investment to the outside world. The recent approval of government for opening up of various sectors for 100% foreign investment is a proven fact that the government is keen on the development of the country at a fast pace.

2. Growth of FDI and FII

During the last five decades, there have been significant changes in approaches towards FDI policies in India. The FDI policy was tuned in with the developments in the industrial policies and also the foreign exchange situation, from time to time. The post-independence period can be well identified in four distinct phases in the evolution of the policies. The first phase (1950-1967) focused on import substituting industrialization. The attitude towards FDI was very receptive due to limited availability of capital, technology, skills, etc. The foreign investment was considered important, though was sort on mutual advantageous terms only. With the foreign exchange crisis in 1957-58, FDI policies were further liberalized and offered a host of incentives and tax concessions. The market seeking FDI was encouraged by locational advantage in production. Thus, during this phase, the country had given a cautious welcome to the foreign capital. By the middle sixties i.e. The second phase (1967-1980) the investment in various industries increased. India's scientific and technological knowledge and infrastructure were developing and human resource skills were getting more skilled and constraints on local supply of capital decreased. The liberal attitude of government lured foreign capital from developed countries like U.S.A., Japan, Germany, etc. However, due to the outflow on account of servicing of FDI during this period the government had to adopt stringent and restrictive policies on account of foreign capital flows like limiting the list of industries in which FDI was previously allowed, restrictions on renewals of foreign collaborations agreements, putting pressure on foreign investors to use Indian consultancy services wherever available. During this period the Foreign Exchange Regulation Act (FERA), 1973 was setup to regulate flow of foreign funds and FDI in India. The third phase (1980-1990) in the evolution of foreign policies saw a gradual liberalization of FDI policies due to the deterioration of foreign exchange position in the wake to the second oil crisis. With the soaring oil prices, India failed to boost her manufactured exports which lead to deterioration in the Balance of Payment. During this phase the policies were liberalized to attract more foreign investors holding equity in export-oriented units. In the early period of the fourth phase (1991 onwards), Indian economy faced extreme Balance of Payment crisis. There was marked rise in oil prices due to Gulf War. The external foreign debts were the highest during this period and the foreign reserves were not sufficient to balance the debt. Thus, there was a paradigm shift in the policies on foreign investment and trade was adopted. In this critical situation, the then Prime Minister of India, Dr. Manmohan Singh with the help of World Bank and IMF introduced the macro-economic stabilization and structural adjustment program. Industrial Policy statement of July 1991 was adopted with the objective of "foreign investment and technology collaboration will be welcomed to obtain higher technology to increase exports and to expand production base". The Industrial Policy Statement of 1991 followed an 'open door' policy on foreign investment and technology transfer. Thus, during fourth phase, favorable policy environment consisting of the liberalization policies on foreign investment, foreign technology collaboration, foreign trade and foreign exchange, have been exerting a positive influence on attracting foreign firms' investment and business operations in the country. New sectors such as mining, banking, telecommunications, highways, construction, airports, hotel and tourism, courier service and management have been thrown open for FDI and private Indian firms too. FDI, however, was still not permitted in industrial sectors in interest of national safety like i) arms and ammunition, ii) atomic energy, iii) railway transport, iv) lottery and chit funds.

India tried different routes to attract FDI: early breaks were for investment in tax-incentives backward districts, next was public-private partnerships, and then special economic zones. The paces of FDI inflows in India initially were low due to regulatory policy framework but in 2001, the Goldman Sachs Brics report reshaped the perception of India. This report positioned India as a long-term growth opportunity. FDI started flowing in and since then there is a sharp rise in investment flows because of the new policy that has broadened the scope of FDI and FII. The Indian Government's attitude towards foreign investment has changed significantly during the past decade. Automatic approval was granted in specified high-priority industries for up to 51 per cent direct foreign investment and in trading companies engaged primarily in export activities. An FII may invest in the capital of an Indian Company under the Portfolio Investment Scheme which limits the individual holding of an FII to 10% of the capital of the company and the aggregate limit for FII investment to 24% of the capital of the company. This aggregate limit of 24% can be increased to the sectoral cap/statutory ceiling, as applicable, by the Indian Company concerned through a resolution by its Board of Directors followed by a special resolution to that effect by its General Body and subject to prior intimation to RBI. The aggregate FII investment, in the FDI and Portfolio Investment Scheme, should be within the above caps. But a committee was set up under Arvind Mayaram to dilute the difference between FDI and FII on the basis of the share they have in the company. Where the stake is less than 10% it would be termed as FII and where it's more than 10% it would be termed as FDI.

	FDI*	%age growth over previous year (in US\$ terms)	Net FII*	Nominal GDP per capita	Gap between FDI and FII
2000	4029	-	1847	443.8645	2182
2001	6130	(+)52%	1505	450.7929	4625
2002	5035	(-)18%	377	463.8093	4658
2003	4322	(-)14%	10918	534.7138	-6596
2004	6051	(+)40%	8686	637.1015	-2635
2005	8961	(+)48%	9926	734.6207	-965
2006	22826	(+)146%	3225	819.2571	19601
2007	34843	(+)53%	20328	1027.376	14515
2008	41873	(+)20%	(-)15017	1086.701	56890

	FDI*	%age growth over previous year (in US\$ terms)	Net FII*	Nominal GDP per capita	Gap between FDI and FII
2009	37745	(-)10%	29048	1104.557	8697
2010	34847	(-)8%	29442	1370.47	5405
2011	46553	(+)34%	16813	1528.49	29740

Table 1: FDI, FII and Economic Growth

Source: Department Of Industrial Policy and Promotion and Self Compiled

* US Dollars at Current Prices and Current Exchange Rates in Millions

3. Objectives of the Study

The present study tries to do a comparative analysis of FDI and FII and their contribution towards economic growth. In today's times of rapid growth both FDI and FII are an important source of foreign funds for any country especially developing country like India. India is rapidly growing for which it needs to channelize foreign funds from all over the world. Thus, the Indian economy is increasingly becoming part of global inter-connectedness, with changes in policy contributing to changes in both the nature and magnitude of capital flows. However, the current financial crisis has stressed upon the volatile nature of foreign capital flows to developing countries with changes in risk perception and attitudes towards investment in countries most affected by global financial turbulence. The volatile nature of foreign funds affects the flow of FII and FDI in varying degrees. The continuous adjustments in investment inflows and outflows of foreign funds in India, strongly affects the economic growth of the country. Thus, new policy changes have to be adopted and old one amended from time to time in order to have robust growth of the country. The recent amendments in FDI policies indicate the same.

The study attempts to discover the implications of FDI and FII flow on Economic growth of India. The policies are changed with changing economic environment in order to attract foreign funds to increase the speed of economic growth in India. Hence, following are objectives of this study.

- The study aims to find relationship between FDI and Economic Growth.
- To highlight the relationship between FII and Economic Growth.
- To analyse the relationship between FDI and FII.
- To find the degree of Correlation between foreign institutional investments, foreign direct investment and the real economic growth in India over a period 2000 to 2012.

4. Literature Review

- **T. T. Ram Mohan (2005)** analyses the different types of institutional investors in mature markets and their investment stance with respect to emerging markets. The study also highlights the trends in FII flows and their importance in the capital market as well as in relation to the balance of payments. The study highlights that flows of private capital in form of FII in recent years have amplified the Forex reserves in emerging markets and helped in enhancing capital markets in India. The study further analyses the implications of an enlarged FII presence in terms of stock market and macroeconomic volatility. The study concluded that drastic increased in FII flows in Indian economy has shifted the focus of equity market from mutual funds to FII inflows. FII share in the Sensex companies are increasing to impact the market movements which sometimes poses concern to authorities such as RBI. The presence of FIIs helps in raising standards of disclosure and governance but still their presence in market is said to cause volatility in markets. The study highlights that the flow of FII into India has been positive and greater as compared to other emerging countries like Malaysia and Indonesia during Asian crisis. While in theory FIIs activity could destabilise the market and the economy at large in emerging countries like India but their presence doesn't destabilise the market although size of flow could vary at times creating movements in market but no large volatility as there is no outflow as such.
- **Parthaprati Pal (1998)** in his study does not supports the mainstream view that the influx of portfolio investment leads to economic development. The study highlights that FII flows have failed to invigorate the stock market in India. The author argues the notion that FII flows augments a country's stock market and economy. The study also discusses the developments of Indian stock market since 1980s. The study also highlights the institutional factors about FIIs in India. It further analyses the linkages between the stock market and domestic saving rate both theoretically and at empirical level in context of Indian experience. The study states that benefits of FII accrue through the stock markets of any country which in practice not always materialises in a positive way for any country. Secondary markets transaction often leads to speculation, which creates a situation where every trader in stock market tries to outguess the market in foresee variations in short term financial ratios, which give rise to more speculations which further hinders long term investment growth, thus affecting economic growth of a country. Outflow of FIIs due to a little blip in the economy or unstable political situations shows that international inflows are volatile even when there are huge inflows which cause currency appreciation. Markets not always react rationally and tend to overreact usually by speculative activities and no real changes creating hot money in terms of FII and thus making developing countries vulnerable to speculative attack. This study thus finds that that financial liberalisation does not necessarily lifts the level of domestic saving and investment rather it leads to increased financial instability. Financial activities have increased financial deepening, but without benefiting industry and commerce

- **R. Nagaraj (2003)** in their paper highlights the trends and issues in FDI in India in the 1990s, and compares them with those in China. On the basis of the analyses and comparisons the study suggests a realistic foreign investment policy. The study highlights the point that while most of the approvals is for infrastructure, however actual inflow seems to be going into registered manufacturing, mostly in consumer durables and automotive industries while very less has flowed into capital goods industries. Much of the realised FDI has also come in as fully owned subsidiaries (or branch plants) of their parents abroad. The study highlights the issue that though FDI flow in India increased post 1991, it is insignificant in comparison to inflows in China. The reason for this is failure of India's reforms to increase inflows of foreign capital to large extent whereas exceptional growth and export performance is attributed to greater foreign capital inflow in China leading to higher ranking of China in UNCTAD's ranking of countries in terms of foreign investment. According to IFC (2002), India does not follow the standard IMF definition as it excludes (i) external commercial borrowings, i.e. ADRs/GDRs, (ii) reinvested profits and (iii) subordinated debt. This leads to underestimation of India's FDI inflows. The study compares FDI inflows in China and India and highlights that China's foreign investment policy is more restrictive in nature than of India's still China's FDI inflow is greater. Thus, India should focus more on how effectively it uses its external openness to amplify the domestic ability and attract more foreign inflows and access foreign market for its labour intensive products as China has exactly so done.
- **Argiro Moudatsou (2003)** empirically analyses the growth effects of FDI in European countries while controlling for other growth determinants. The estimates of the growth of FDI for each country in isolation and by posing the data for the whole Union is obtained by using the data over the period 1980-1996. The country-specific estimate suggested that growth determinants vary across EU members and that only past FDI inflows have a significant effect on growth. Interestingly, when data are pooled, the empirical results showed that FDI has a positive effect on the growth rate of EU economies.
- **Kalle Pajunen (2006)** analyses the casual complexity and diversity in relation to the influence of institutions on the FDI of multinational enterprises. The study applies a new methodological approach of fuzzy-set analysis, on the data of 47 host countries for the period of 1999-2003. The paper then analyses how and why some countries with different degrees of membership in different institutional constraints either attract or do not attract FDI. The results of the study show that institutional factors have varied influences, wherein even similar institutions with different outcomes may relate to diverse regional outcomes if different regional categories of countries are observed. Countries may neither be attractive nor unattractive owing to the presence or absence of a single institutional factor. Instead, the outcome usually results from a combination of institutional conditions.

5. Data & Methodology

For the purpose of gathering data to analyze relationship between FII, FDI, economic growth the secondary data has been taken from World Bank, OECD, DIPP. Time period for the study is taken as 2000 to 2012 and annual data has been used. Nominal GDP per capita is used as a proxy for economic growth; annual FDI and FII investment data have been taken.

The first step in the time series analysis is to check for stationarity and for that augmented dickey fuller test has been used. To find the association between the three variables namely, FDI, FII, economic growth, correlation has been calculated and further the flow of causality is checked using granger causality and Johansen co-integration statistics.

SL. NO.	Country	Amount of FDI inflows		% with total FDI inflows
		(In Rs Crore)	(In US \$ Mn)	
1	Mauritius	328,729.06	71,378.36	38.23
2	Singapore	85,840.61	18,660.74	9.99
3	United Kingdom	77,933.08	17,083.44	9.15
4	Japan	66,464.78	13,878.44	7.43
5	U.S.A	49,942.79	10,940.56	5.86
6	Netherlands	38,265.20	8,208.03	4.40
7	Cyprus	31,523.76	6,741.41	3.61
8	Germany	23,403.15	5,092.06	2.73
9	France	15,906.89	3,396.08	1.82
10	UAE	10,962.34	2,358.98	1.26

Table 2: Statement on Country-Wise FDI Equity Inflows from April, 2000 to November, 2012

Source: Department Of Industrial Policy and Promotion

Sectors/Activities falling under Government Route with percentage of FDI permitted

FDI policy in 2013 made certain proposals few of which were accepted and the new policy for FDI are as:

Sector/Activity	Before the proposal		After the proposal	
	% of FDI /Equity	Entry Route	% of FDI / Equity	Entry Route
Defense Sector	26%	Government Route	No Change	Higher limits of foreign investment in "state of-the-art" manufacturing would be considered by the CCS
Insurance Sector	26%	Automatic Route	49%	Automatic Route
Telecom Services	74%	Automatic up to 49% Government route beyond 49% and up to 74%	100%	Automatic up to 49% Government route beyond 49% and up to 100%
Tea Plantation	100%	Government Route	100%	Automatic up to 49% Government route beyond 49% and up to 100%
Asset Reconstruction Company	74% of paid-up capital of ARC (FDI+FII)	Government Route	100%	Automatic up to 49% Government route beyond 49% and up to 100%
Petroleum & Natural Gas	49%	Government Route	49%	Automatic Route
Commodity Exchanges	49% (FDI & FII) + [Investment by Registered FII under Portfolio Investment Scheme (PIS) will be limited to 23% and Investment under FDI Scheme limited to 26%]	Government Route (For FDI)	49%	Automatic Route
Power Exchanges	49% (FDI & FII) FDI limit of 26 per cent and an FII limit of 23 per cent of the paid-up capital	Government Route (For FDI)	49%	Automatic Route
Stock Exchanges/ ClearingCorporations	49% (FDI & FII) FDI limit of 26 per cent and an FII limit of 23 per cent of the paid-up capital	Government Route(For FDI)	49%	Automatic Route
Credit Information Companies	49% (FDI & FII)	Government Route	74%	Automatic Route
Courier Services	100%	Government Route	100%	Automatic Route
Single Brand product retail trading	100%	Government Route	100%	Automatic up to 49% Government route beyond 49% and up to 100%

Table 3
Source: Mondaq

6. Empirical Analysis

The unit root tests is one of the most widely used method for checking stationarity. In the AR (1) model:

$$Y_t = \phi Y_{t-1} + \mu_t \quad (1)$$

μ_t being the white noise.

In general there are three cases:

Case1: $|\phi| < 1$ = series is stationary

Case 2: $|\phi| > 1$ = series explodes

Case 3: $|\phi| = 1$ = series contains a unit root and is non-stationary.

So if $\phi = 1$, then Y_t contains a unit root.

Manipulating equation 1 we get:

$$\Delta Y_t = \delta Y_{t-1} + \mu_t \tag{2}$$

Where $\delta = \phi - 1$

Now hypothesis being $\delta = 0$, then $\phi=1$ that is there is a unit root specifying that the time series under consideration is non-stationary.

A series Y_t is integrated of order one i.e. $Y_t \sim I(1)$ and contains a unit root, if Y_t is non-stationary but ΔY_t is stationary.

Here the Augmented Dickey fuller (ADF) test has been used for checking stationarity. The ADF test includes extra lagged terms of the dependent variable in order to eliminate autocorrelation. The lag length on these extra terms is either determined by Akaike Information criteria (AIC) or Schwartz Bayesian Criterion (SBC). Three forms of ADF that is without constant, with constant and with constant and intercept have been checked. We started with unit root testing with trend and intercept/constant term which is the most general form and then proceeded to only intercept and no intercept form. The Augmented Dickey-Fuller (ADF) unit root test is used for this purpose.

$$\Delta Y_t = \alpha_1 Y_{t-1} + \sum_{j=1}^P \gamma_j \Delta Y_{t-j} + \varepsilon_t \dots\dots\dots (3)$$

$$\Delta Y_t = \alpha_0 + \alpha_1 Y_{t-1} + \sum_{j=1}^P \gamma_j \Delta Y_{t-j} + \varepsilon_t \dots\dots\dots (4)$$

$$\Delta Y_t = \alpha_0 + \alpha_1 Y_{t-1} + \alpha_2 t + \sum_{j=1}^P \gamma_j \Delta Y_{t-j} + \varepsilon_t \dots\dots\dots (5)$$

Where ε_t is white noise. The additional lagged terms are included to ensure that the errors are uncorrelated. The tests are based on the null hypothesis (H_0): Y_t is not $I(0)$. If the calculated DF and ADF statistics are less than their critical values from Fuller’s table, then the null hypothesis (H_0) is accepted and the series are non-stationary or not integrated of order zero. (6)

FDI at level ADF test statistic	0.0647	Null hypothesis of unit root accepted
FII at level ADF test statistic	0.0390	Null hypothesis of unit root rejected
GDP per capita at level ADF test statistic	0.0850	Null hypothesis of unit root accepted
FDI first difference ADF test statistic	0.0549	Null hypothesis of unit root accepted
GDP per capita first difference ADF test statistic	0.0399	Null hypothesis of unit root rejected
FDI natural log ADF test statistic	0.0293	Null hypothesis of unit root rejected

Table 4: ADF Test Results for FDI, FII and GDP Per Capita
At 5% Significance Level

ADF results show that FDI net investment is not stationary its even non stationary at first difference and second difference and so natural log has been taken for the series. FII is stationary at the level and GDP has been made stationary by taking the first difference.

	DGDP	LFDI	FII
DGDP	1.000000	0.483271	0.542745
LFDI	0.483271	1.000000	0.312228
FII	0.542745	0.312228	1.000000

Table 5: Correlation between Stationary Series of FDI, FII and GDP Per Capita

But because of the limitation of correlation as discussed above, not being able to determine the precedence of the variable in the cause-effect relationship, Granger Causality tests have been applied to test the above stated hypotheses. Causality test developed by Granger (1969), could be summarized as follows.

$$R_t = \alpha + \sum_{i=1}^m \beta_i R_{t-i} + \sum_{i=1}^m \lambda_i F_{t-i} + \varepsilon_{R_t}$$

$$F_t = \mu + \sum_{i=1}^m \delta_i R_{t-i} + \sum_{i=1}^m \phi_i F_{t-i} + \varepsilon_{F_t}$$

It shows the short term relation between two variables at a time. Results obtained from the stationary series are as:

Lags	Causality
1	<ul style="list-style-type: none"> No causality between FDI and GDP FII → GDP No causality between FDI and FII
2	<ul style="list-style-type: none"> No causality between FDI and GDP GDP → FII No causality between FDI and FII
3	<ul style="list-style-type: none"> No causality between FDI and GDP No causality between FII and GDP No causality between FDI and FII

Table 6

Results above show that there is no causality between the variables except between FII and GDP and the causality runs from FII to GDP at lag 1 while it reverses at lag 2.

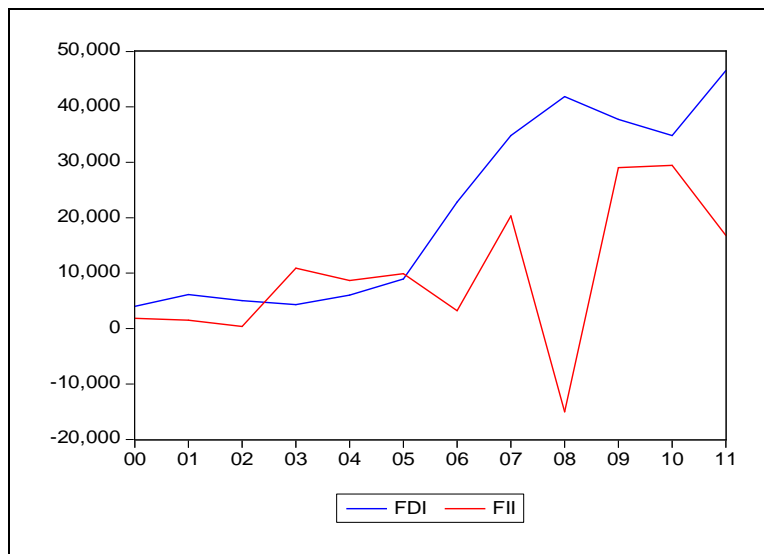


Figure 1: GAP between FDI and FII Investment

7. Conclusion

FDI and FII both bring the much needed capital in the country but it is the FDI that should be preferred as it is much more stable as compared to FII which are speculative in nature. However, in India it has been much easier to attract FII because of less procedural requirements as compared to FDI where the licensing requirements are too burdensome. Various studies have been done to find the relation between foreign capital inflow and economic growth of an economy and same has been done in the present study using annual data from 2000 to 2012. Results show that except FII and GDP at a lag of 2 years, there is no causal relation between the variables being considered under the study.

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