Foreign Direct Investment (FDI)

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What is FDI (1/2)

According to OECD, FDI

- ‘An **investment involving a long-term relationship and reflecting a lasting interest and control by a resident entity in one economy (foreign direct investor or parent enterprise) in an enterprise resident in an economy other than that of the foreign direct investor**’.
- If such an investment is 10 per cent or more of a company’s equity, it is FDI

Key characteristics of FDI

- **A**n Active and Direct Investment,
- Long term capital Investment,
- Invests in both financial & non-financial assets,
- it is Stable.
- An overseas investor can buy directly into a company involved in manufacturing, infrastructure development, banking, insurance, retail, etc.

Objectives of FDI

- **Resource seeking** : To seek and secure natural resources e.g. minerals, raw materials, or lower labor costs for the investing company
- **Market seeking**: To identify and exploit new markets for the firms' finished products
- **Efficiency seeking** (global sourcing FDI):
  - ➢ To restructure its existing investments to achieve an efficient allocation of international economic activity of the firms
  - ➢ firms seek to benefit from differences in product and factor prices and to diversify risk
  - ➢ Global sourcing: resource saving and improved efficiency by rationalizing the structure of their global activities.
  - ➢ Undertaken primarily by network based MNCs with global sourcing operations.

Role of FDI

- FDI is long term investment and the investor has complete control over the company.
- FDI investors invest in financial and non-financial assets like resources, technical know-how along with securities.
- For an economy as a whole, FDI creates productive assets by investing in factories, machinery & skill and superior technology.
- In that sense, FDI brings in long-term capital for an economy.
- FDI plays significant role in accelerating growth of a country and its development.

FDI and FPI

- **FDI is not merely a transfer of monetary funds**;
  - a form of controlling ownership
  - distinct from **foreign portfolio investment** (FPI) by a notion of direct control.
- FPI refers to the investment made in the financial assets of an enterprise, based in one country, by the foreign investors.

Distinction between FDI and FPI

FDI	FPI
Active Investment	Passive Investment
Direct Investment	Indirect investment
Long term capital	Short Term capital
Invests in financial & non-financial assets	Invests only in financial assets
Ownership and managerial control	Only ownership
Stable	Volatile
Entry & exit barriers exist	Entry & exit very easy

At a Glance : FDI Policy in India

Pre -1991

FDI Allowed selectively up to 40%

1991

Automatic Route introduced

FDI up to 51 % Allowed In 35 priority sectors

1997

FDI up to 100 % allowed in some sectors

FDI up to 50% to 74% allowed in 111 sectors

2000

FDI up to 100% allowed in most sectors

Subject to a small negative list

2000-10

New sectors opened

FDI limits increased

Procedures Further simplified

FDI Policy in India (1/2)

FDI permitted in India under the following forms of investments:

❖Through financial collaborations

❖Through joint ventures and technical collaborations

❖Through capital markets via Euro issues

❖Through private placements or preferential allotments

FDI Policy in India (2/2)

FDI permitted through either

- ❖ Automatic route wherein foreign entity doesn't require GOI's approval; Or
- ❖ Government route wherein prior to investment, GOI's approval required.
- ❖ GOI's approval considered by the Foreign Investment Promotion Board (FIPB), Department of Economic Affairs, Ministry of Finance.

- FDI in India mainly introduced in 1991 under the FEMA (FEMA "facilitating external trade and payments and promoting the orderly development and maintenance of foreign exchange market in India").
- **Negative list**: prohibited in sectors like atomic energy, tobacco products, real estate business, etc.
- Government has put in place an investor friendly policy on FDI, under which FDI up to 100% is permitted on the automatic route in most sectors/ activities.
- FDI policy reforms in a number of sectors such as Defence, Construction Development, Insurance, Pension, Other Financial Services, Asset reconstruction Companies, Broadcasting, Civil Aviation, Pharmaceuticals, Trading undertaken.

Methods of FDI

- ❖ **Subsidiary or Associate Company** : One way to enter another country's market is through setting up a subsidiary in other country.
- ❖ That helps in getting market access to other country and use its resources
  - ➢ e.g. affiliate and subsidiary banks are the most popular setups for foreign market entry.
- ❖ **Merger or Acquisition**: Another way to enter a country is by merger.
  - ➢ e.g. Sun pharma acquisition of Ranbaxy.
- ❖ **Greenfield Investment**: FDI is made in new/upcoming facilities.
- ❖ These are the main area of interest for the host nation as it boosts expansion, economy, jobs and technological advances.
  - ➢ e.g. Walmart opening retail stores in India.

Types of FDIs

Broadly, there are **4 types** of FDIs

i. Horizontal FDI

ii. Conglomerate FDI

iii. Vertical FDI

iv. Platform FDI

Horizontal FDI

- Refers to the overseas manufacturing of products and services similar to those the company produces and manufactures in its home market.
- Called ‘horizontal’ because the company duplicates its business activities of its home country in different countries.
- Example: Apple based in the United States opens stores in India
- This type of FDI arises because it is expensive to serve the overseas market by exports because of transportation costs or trade limitations and barriers.
- Similarly, Coke, Pepsi, Samsung, HSBC etc. expanded internationally by way of horizontal FDI.

Conglomerate FDI

- In conglomerate investments, a business acquires an unrelated business in a foreign country
- Company or individual makes a foreign investment in a business that is unrelated to its existing business in its home country.
- Relatively challenging as it requires overcoming two barriers :

    (a) entering a foreign country and

    (b) entering a new industry or market.

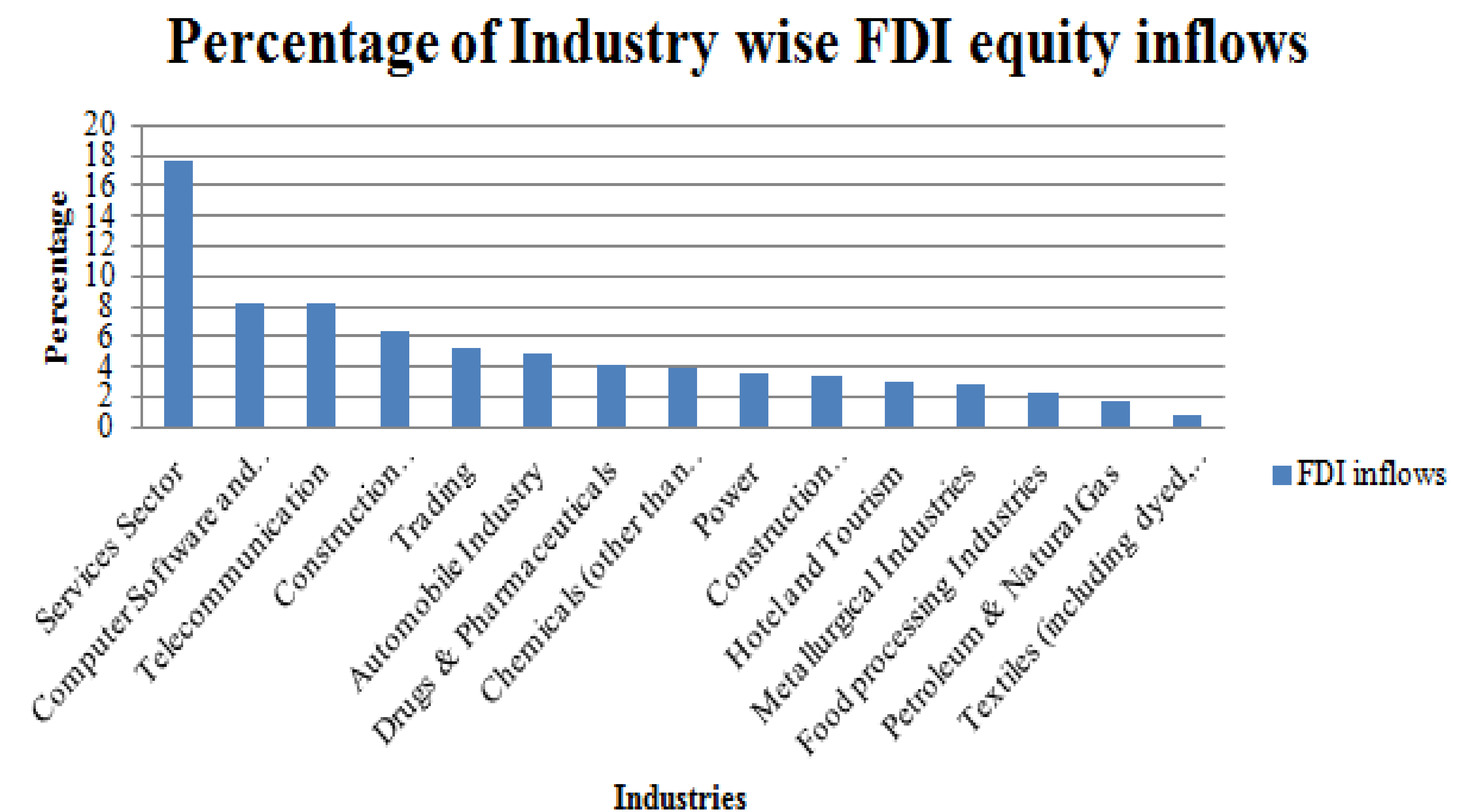
Vertical FDI

- Vertical FDI occurs when firms establish manufacturing facilities in multiple countries, each producing a different input to, or stage of, the company’s production process
- Refers to the overseas manufacturing of products and services similar to those the company produces and manufactures in its home market.
- The MNE produces intermediate goods either forward or backward in the supply stream.
    - Example : Toyota buying a car distributorship in America

Platform FDI

- Export-platform FDI in which the affiliate's output (largely) sold in third markets rather than in the parent or host markets.
- A business expands into another country but the output from the business exported to a third country.
- Example : a three-region model in which there are two identical, large, high-cost economies and a small low-cost economy.
- Pure export-platform production arises in a symmetric case, when a firm in each of the high-cost economies has a plant at home, and a plant in the low-cost country (the South) to serve the other high-cost country.
- An important case arises when there is trade liberalization between one of the high-cost countries and the small, low-cost country.
- The outside high-cost country builds a branch plant inside the free trade area due to market size, but chooses the low-cost country on the basis of cost.

FDI in India: Sector-Wise



Advantages of FDI (1/2)

- **Access to markets**: an effective way to enter into a foreign market.
- **Access to resources**: an effective way to acquire important natural resources, such as precious metals and fossil fuels.
  - e.g.: Oil companies often make tremendous FDIs to develop oil fields.
- **Reduces cost of production**: reduces cost of production if the labor market is cheaper and the regulations are less restrictive in the target foreign market.
  - e.g. : the shoe and clothing industries drastically reduced the costs of production by moving operations to developing countries.

Advantages of FDI (2/2)

FDI exposes national and local governments, local businesses and citizens to new business practices, management techniques, economic concepts and technology that will help develop local business and industries.

- ❖Economic stimulation
- ❖Development of human capital
- ❖Increase in employment
- ❖Access to management expertise, skills, and technology
- ❖For businesses, most of these benefits are based on cost-cutting and lowering risk.
- ❖For host countries, the benefits are mainly economic

Benefits for Businesses

- Market diversification
- Tax incentives
- Lower labor costs
- Preferential tariffs
- Subsidies
- Diversification

Disadvantages of FDI

- The entry of large firms, such as Walmart, may displace local businesses.
- Walmart is often criticized for driving out local businesses that cannot compete with its lower prices.
- In case of profit repatriation, firms may not reinvest profits back into the host country.
- This leads to large capital outflows from the host country.

World Trend on FDI

- Global FDI in 2019 : US $ 1.39 trillion, in the midst of ongoing trade tensions.
- Developing Countries continues to attract more than half of global FDI flows

FDI in India

- **FDI equity inflow in India**
  - US$ 469.99 billion during April 2000 and March 2020.
  - US$ 49.97 billion in 2019-20.
- **the most attractive Sectors in terms of FDI equity inflow**
  - Service sector : US$ 7.85 billion,
  - Computer software and hardware : US$ 7.67 billion,
  - Telecommunications sector : US$ 4.44 billion, and
  - Trading : US$ 4.57 billion

India's hold on Ease of Doing Business

- India improves its rank to 63rd position among 190 countries, reports World Bank's Ease of Doing Business 2020
- Implementation of Insolvency and Bankruptcy Code(IBC), introduced in 2016.
- According to the World Bank Report, the Introduction of IBC has made 470 companies to commence liquidation, more than 120 companies approved reorganization plans.
- In absence of IBC, burdensome for secured creditors to seize companies in default of their loans.
- India made starting a business easier in 2018 by abolishing filing fees for simplified proforma for incorporating a company electronically.

Way Ahead

- With its special investment privileges such as tax exemption, relative lower wages, Government's efforts to improve ease of doing business, India has become an attractive investment destination
- Pitching India as an ideal destination, the Prime Minister Modi stressed that the country offered a gamut of benefits ranging from

  ‘returns with reliability, demand with democracy, stability with sustainability and growth with a green approach’

Before we move to ‘Quiz’

Any Comment/Suggestion/Queries

QUIZ (1/3)

Quiz Question-1

India’s global rank in the inflow of FDI in 2018 was

a) Within the First 10 countries

b) 11^{th}

c) 12^{th}

d) 13^{th}

e) 14^{th}

QUIZ (2/3)

Quiz Question-2

How much was Global flows of FDI in 2019?

a) Below US$ 1 Trillion

b) Between US$ 1 to 1.25 Trillion

c) More than US$ 1.25 Trillion but less than US$ 1.50 Trillion

d) More than S$ 1.50 Trillion

QUIZ (3/3)

Quiz Question-3

Which sector in India attracts the maximum FDI?

a) Services Sector

b) Construction sector

c) Automobiles

d) Pharmaceuticals

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Thank you