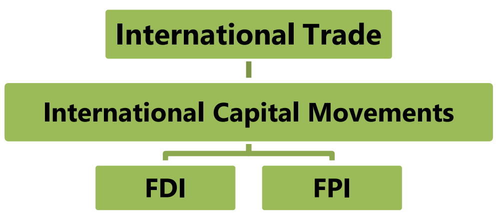
UNIT V: INTERNATIONAL CAPITAL MOVEMENTS

LEARNING OUTCOMES

At the end of this unit, you will be able to:

- Describe the nature and types of foreign capital
- Distinguish between foreign direct investment and foreign institutional investment
- Outline the factors influencing foreign investments
- Elucidate the potential costs and benefits of foreign direct investment
- Explain the state-of-affairs of foreign direct investment in India

UNIT OVERVIEW



5.1 INTRODUCTION

In unit one, our focus was on international trade in goods and services. of late, we find enormous increase in international movement of capital. This phenomenon has received a great deal of attention from not just economists and policy-makers but people in different walks of life including workers' organisations and members of the civil society. In this unit, we shall look into international capital movements; more precisely into why do capital move across national boundaries and what are the consequences of such capital movements. We shall also briefly touch upon the FDI situation in India.

5.2 TYPES OF FOREIGN CAPITAL

The term 'foreign capital' is a comprehensive one and includes any inflow of capital into the home country from abroad and therefore, we need to be clear about the distinction between movement of capital and foreign investment. Foreign capital may flow into an economy in different ways. Some of the important components of foreign capital flows are:

1. Foreign aid or assistance which may be:
   (a) Bilateral or direct inter government grants
   (b) Multilateral aid from many governments who pool funds to international organizations like the World Bank
   (c) Tied aid with strict mandates regarding the use of money or untied aid where there are no such stipulations
   (d) Foreign grants which are voluntary transfer of resources by governments, institutions, agencies or organizations
2. Borrowings which may take different forms such as:
   (a) Direct inter government loans
   (b) Loans from international institutions (e.g. world bank, IMF, ADB)
   (c) Soft loans for e.g. from affiliates of World Bank such as IDA
   (d) External commercial borrowing, and
   (e) Trade credit facilities
3. Deposits from non-resident Indians (NRI)
4. Investments in the form of :
   (i) Foreign portfolio investment (FPI) in bonds, stocks and securities, and
   (ii) Foreign direct investment(FDI) in industrial, commercial and similar other enterprises

A detailed discussion about all types of capital movements is beyond the scope of this unit and therefore, we shall concentrate only on foreign investments.

5.3 FOREIGN DIRECT INVESTMENT (FDI)

When we talk about international investments, we should first of all distinguish between two types of investments namely, Foreign Direct Investment (FDI) and Foreign Portfolio Investment (FPI). Foreign direct investment is defined as a process whereby the resident of one country (i.e. home country) acquires ownership of an asset in another country (i.e. the host country) and such movement of capital involves ownership, control as well as management of the asset in the host country. Foreign direct investment (FDI), according to IMF manual on 'Balance of payments' is "all investments involving a long term relationship and reflecting a lasting interest and control of a resident entity in one economy in an enterprise resident in an economy other than that of the direct investor". This typically occurs through acquisition of more than 10 percent of the shares of the target asset. Direct investment comprises not only the initial transaction establishing the relationship between the investor and the enterprise, but also all subsequent transactions between them and among affiliated enterprises, both incorporated and unincorporated.

According to the IMF and OECD definitions, the acquisition of at least ten percent of the ordinary shares or voting power in a public or private enterprise by non-resident investors makes it eligible to be categorized as foreign direct investment (FDI). India also follows the same pattern of classification. FDI has three components, viz., equity capital, reinvested earnings and other direct capital in the form of intra-company loans between direct investors (parent enterprises) and affiliate enterprises.

Foreign direct investors may be individuals, incorporated or unincorporated private or public enterprises, associated groups of individuals or enterprises, governments or government agencies, estates, trusts, or other organizations or any combination of the above mentioned entities. The main forms of direct investments are: the opening of overseas companies, including the establishment of subsidiaries or branches, creation of joint ventures on a contract basis, joint development of natural resources and purchase or annexation of companies in the country receiving foreign capital.

Direct investments are real investments in factories, assets, land, inventories etc. and involve foreign ownership of production facilities. The investor retains control over the use of the invested capital and also seeks the power to exercise control over decision making to the extent of its equity participation. The lasting interest implies the existence of a long-term relationship between the direct investor and the enterprise and a significant degree of influence by the investor on the management of the enterprise.

Based on the nature of foreign investments, FDI may be categorized as horizontal, vertical or conglomerate.

i) A horizontal direct investment is said to take place when the investor establishes the same type of business operation in a foreign country as it operates in its home country, for example, a cell phone service provider based in the United States moving to India to provide the same service.

ii) A vertical investment is one under which the investor establishes or acquires a business activity in a foreign country which is different from the investor's main business activity yet in some way supplements its major activity. For example; an automobile manufacturing company may acquire an interest in a foreign company that supplies parts or raw materials required for the company.

iii) A conglomerate type of foreign direct investment is one where an investor makes a foreign investment in a business that is unrelated to its existing business in its home country. This is often in the form of a joint venture with a foreign firm already operating in the industry as the investor has no previous experience.

   Yet another category of investments is 'two- way direct foreign investments' which are reciprocal investments between countries that occur when some industries are more advanced in one nation (for example, the computer industry in the United States), while other industries are more efficient in other nations (such as the automobile industry in Japan).

5.4 FOREIGN PORTFOLIO INVESTMENT (FPI)

Foreign portfolio investment is the flow of what economists call 'financial capital' rather than 'real capital' and does not involve ownership or control on the part of the investor. Examples of foreign portfolio investment are the deposit of funds in an Indian or a British bank by an Italian company or the purchase of a bond (a certificate of indebtedness) of a Swiss company or of the Swiss government by a citizen or company based in France. Unlike FDI, portfolio capital, in general, moves to investment in financial stocks, bonds and other financial instruments and is effected largely by individuals and institutions through the mechanism of capital market. These flows of financial capital have their immediate effects on balance of payments or exchange rates rather than on production or income generation.

Foreign portfolio investment (FPI) is not concerned with either manufacture of goods or with provision of services. Such investors also do not have any intention of exercising voting power or controlling or managing the affairs of the company in whose securities they invest. The singular intention of a foreign portfolio investor is to earn a remunerative return through investment in foreign securities and is primarily concerned about the safety of their capital, the likelihood of appreciation in its value, and the return generated. Logically, portfolio capital moves to a recipient country which has revealed its potential for higher returns and profitability.

Following international standards, portfolio investments are characterised by lower stake in companies with their total stake in a firm at below 10 percent. It is also noteworthy that unlike the FDIs, these investments are typically of short term nature, and therefore, are not intended to enhance the productive capacity of an economy by the creation of capital assets.

Portfolio investors will evaluate, on a separate basis, the prospects of each independent unit in which they might invest and may often shift their capital with changes in these prospects. Therefore, portfolio investments are, to a large extent, expected to be speculative. Once investor confidence is shaken, such capital has a tendency to speedily shift from one country to another, occasionally creating financial crisis for the host country.

Table 4.5.1

Foreign direct investment (FDI) VS Foreign portfolio investment (FPI)

Foreign direct investment (FDI)	Foreign portfolio investment (FPI)
Investment involves creation of physical assets	Investment is only in financial assets
Has a long term interest and therefore remain invested for long	Only short term interest and generally remain invested for short periods
Relatively difficult to withdraw	Relatively easy to withdraw
Not inclined to be speculative	Speculative in nature
Often accompanied by technology transfer	Not accompanied by technology transfer
Direct impact on employment of labour and wages	No direct impact on employment of labour and wages

Enduring interest in management and control	No abiding interest in management and control
Securities are held with significant degree of influence by the investor on the management of the enterprise	Securities are held purely as a financial investment and no significant degree of influence on the management of the enterprise

5.5 REASONS FOR FOREIGN DIRECT INVESTMENT

As we know, economic prosperity and the relative abundance of capital are necessary prerequisites for export of capital to other countries. Many economies and organisations have accumulation of huge mass of reserve capital seeking profitable use. The primary aim of economic agents being maximisation of their economic interests, the opportunity to generate profits available in other countries often entices such entities to make investments in other countries. The chief motive for shifting of capital between different regions or between different industries is the expectation of higher rate of return than what is possible in the home country. Investment in a host country may be found profitable by foreign firms because of some firm-specific knowledge or assets (such as superior management skills or an important patent) that enable the foreign firm to gainfully outperform the host country's domestic firms. There are many other reasons (as listed below) for international capital movements which have found adequate empirical support. Investments move across borders on account of:

(i) the increasing interdependence of national economies and the consequent trade relations and international industrial cooperation established among them

(ii) internationalisation of production and investment of transnational corporations in their subsidiaries and affiliates.

(iii) desire to reap economies of large-scale operation arising from technological growth

(iv) lack of feasibility of licensing agreements with foreign producers in view of the rapid rate of technological innovations

(v) necessity to retain direct control of production knowledge or managerial skill (usually found in monopolistic or oligopolistic markets) that could easily and profitably be utilized by corporations

(vi) desire to procure a promising foreign firm to avoid future competition and the possible loss of export markets

(vii) risk diversification so that recessions or downturns may be experienced with reduced severity

(viii) shared common language or common boundaries and possible saving in time and transport costs because of geographical proximity

(ix) necessity to retain complete control over its trade patents and to ensure consistent quality and service or for creating monopolies in a global context

(x) promoting optimal utilization of physical, human, financial and other resources

(xi) desire to capture large and rapidly growing high potential emerging markets with substantially high and growing population

(xii) ease of penetration into the markets of those countries that have established import restrictions such as blanket bans, high customs duties or non-tariff barriers which make it difficult for the foreign firm to sell in the host-country market by 'getting behind the tariff wall'.

(xiii) lower environmental standards in the host country and the consequent relative savings in costs

(xiv) stable political environment and overall favourable investment climate in the host country

(xv) higher degree of openness to foreign capital exhibited by the recipient country and the prevalence of preferential investment systems such as special economic zones to encourage direct foreign investments

(xvi) the strategy to obtain control of strategic raw material or resource so as to ensure their uninterrupted supply at the lowest possible price; usually a form of vertical integration

(xvii) desire to secure access to minerals or raw material deposits located elsewhere and earn profits through processing them to finished form (Eg.FDI in petroleum)

(xviii) the existence of low relative wages in the host country because of relative labour abundance coupled with shortage and high cost of labour in capital exporting countries, especially when the production process is labour intensive.

(xix) lower level of economic efficiency in host countries and identifiable gaps in development

(xx) tax differentials and tax policies of the host country which support direct investment. However, a low tax burden cannot compensate for a generally fragile and unattractive FDI environment

(xxi) inevitability of defensive investments in order to preserve a firm's competitive position

(xxii) high gross domestic product and high per capita income coupled with their high rate of growth . There are also other philanthropic objectives such as strengthening of socio-economic infrastructure, alleviation of poverty and maintenance of ecological balance of the host country ,and

(xxiii) prevalence of high standards of social amenities and possibility of good quality of life in the host country

Table 4.5.2

Host Country Determinants of Foreign Direct Investment

Economic Determinants	**Policy Framework**
Market -seeking FDI:	Economic, political, and social stability
Market size and per capita income	Rules regarding entry and operations
Market growth	Standards of treatment of foreign affiliates
Access to regional and global markets	Policies on functioning and structure of markets (e.g., regarding competition, mergers)
Country-specific consumer preferences	International agreements on FDI
Structure of markets	Privatization policy
Resource - or asset-seeking FDI:	Trade policies and coherence of FDI and trade policies
Raw materials	Tax policy
Low -cost unskilled labour	***Business Facilitation***
Availability of skilled labour	Investment promotion (including image building and investment-generating
Technological, innovative, and other created assets (e.g., brand names)	
Physical infrastructure	

Efficiency -seeking FDI: Costs of above physical and human resources and assets (including an adjustment for productivity) Other input costs (e.g., intermediate products, transport costs) Membership of country in a regional integration agreement, which could be conducive to forming regional corporate networks	activities and investment-facilitation services) Investment incentives "Hassle costs" (related to corruption and administrative efficiency) Social amenities (e.g., bilingual schools, quality of life) After-investment services

Source :International economics (7th ed) International Economics, Dennis R. Appleyard; Alfred J. Field; Steven L. Cobb(P237)

Factors in the host country discouraging inflow of foreign investments are infrastructure lags, high rates of inflation, balance of payment deficits, poor literacy and low labour skills, rigidity in the labour market, bureaucracy and corruption, unfavourable tax regime, cumbersome legal formalities and delays, small size of market and lack of potential for its growth, political instability, absence of well-defined property rights, exchange rate volatility, poor track-record of investments, prevalence of non-tariff barriers, stringent regulations, lack of openness, language barriers, high rates of industrial disputes, lack of security to life and property, lack of facilities for immigration and employment of foreign technical and administrative personnel, double taxation and lack of a general spirit of friendliness towards foreign investors.

5.6 MODES OF FOREIGN DIRECT INVESTMENT (FDI)

Foreign direct investments can be made in a variety of ways, such as:

(i) Opening of a subsidiary or associate company in a foreign country,

(ii) Equity injection into an overseas company,

(iii) Acquiring a controlling interest in an existing foreign company,

(iv) Mergers and acquisitions(M&A)

(v) Joint venture with a foreign company.

(vi) Green field investment (establishment of a new overseas affiliate for freshly starting production by a parent company).

5.7 BENEFITS OF FOREIGN DIRECT INVESTMENT

The benefits from and concerns about FDI are widely discussed and well documented. While recognizing the fact that there are also benefits and costs to the home country from capital outflow, in this unit we focus only on host-country effects of FDI with particular attention to the developing countries. Following are the benefits ascribed to foreign investments:

1. Entry of foreign enterprises usually fosters competition and generates a competitive environment in the host country. The domestic enterprises are compelled to compete with the foreign enterprises operating in the domestic market. This results in positive outcomes in the form of cost-reducing and quality-improving innovations, higher efficiency and increasing variety of better products and services at lower prices ensuring wider choice and welfare for consumers

2. International capital allows countries to finance more investment than can be supported by domestic savings. The provision of increased capital to work with labour and other resources available in the host country can enhance the total output (as well as output per unit of input) flowing from the factors of production.

3. From the perspective of emerging and developing countries, FDI can accelerate growth and foster economic development by providing the much needed capital, technological know-how, management skills and marketing methods and critical human capital skills in the form of managers and technicians. The spill-over effects of the new technologies usually spread beyond the foreign corporations. In addition, the new technology can clearly enhance the recipient country's production possibilities.

4. Competition for FDI among national governments also has helped to promote political reforms important to attract foreign investors, including legal systems and macroeconomic policies.

5. Since FDI involves setting up of production base (in terms of factories, power plants, etc.) it generates direct employment in the recipient country. Subsequent FDI as well as domestic investments propelled in the downstream and upstream projects that come up in multitude of other services generate multiplier effects on employment and income.

6. FDI not only creates direct employment opportunities but also, through backward and forward linkages, generate indirect employment opportunities.

This impact is particularly important if the recipient country is a developing country with an excess supply of labour caused by population pressure.

7. Foreign direct investments also promote relatively higher wages for skilled jobs. More indirect employment will be generated to persons in the lower-end services sector occupations thereby catering to an extent even to the less educated and unskilled persons engaged in those units.

8. Foreign corporations provide better access to foreign markets. Unlike portfolio investments, FDI generally entails people-to-people relations and is usually considered as a promoter of bilateral and international relations. Greater openness to foreign capital leads to higher national dependence on international investors, making the cost of discords higher.

9. There is also greater possibility for the promotion of ancillary units resulting in job creation and skill development for workers.

10. Foreign enterprises possessing marketing information with their global network of marketing are in a unique position to utilize these strengths to promote the exports of developing countries. If the foreign capital produces goods with export potential, the host country is in a position to secure scarce foreign exchange which can be used to import needed capital equipments or materials to assist the country's development plans or to ease its external debt servicing.

11. If the host country is in a position to implement effective tax measures, the foreign investment projects also would act as a source of new tax revenue which can be used for development projects.

12. It is likely that foreign investments enter into industries in which scale economies can be realized so that consumer prices might be lowered. Domestic firms might not always be able to generate the necessary capital to achieve the cost reductions associated with large-scale production.

13. Increased competition resulting from the inflow of foreign direct investments facilitates weakening of the market power of domestic monopolies resulting in a possible increase in output and fall in prices.

14. Since FDI has a distinct advantage over the external borrowings, it is considered to have a favourable impact on the host country’s balance of payment position, and

15. Better work culture and higher productivity standards brought in by foreign firms may possibly induce productivity related awareness and may also contribute to overall human resources development.

5.8 POTENTIAL PROBLEMS ASSOCIATED WITH FOREIGN DIRECT INVESTMENT

In the above section, we have seen that a wide variety of benefits may result from an inflow of foreign direct investment. These gains do not occur in all cases, nor do they occur in the same magnitude. Despite the arguments which vehemently favour direct investments in host countries, many are highly critical of the impact of foreign capital, especially on developing economies. They argue that foreign entities are highly focused on profits and have an eye on exploiting the natural resources and are almost always not genuinely interested in the development needs of host countries. Foreign capital is perceived by the critics as an instrument of imperialism, or as a perpetrator of dependence and inequality both between nations and within nations.

Following are the general arguments put forth against the entry of foreign capital.

1. FDIs are likely to concentrate on capital-intensive methods of production and service so that they need to hire only relatively few workers. Such technology is inappropriate for a labour-abundant country as it does not support generation of jobs which is a crucial requirement to address poverty and unemployment which are the two fundamental areas of concern for the less developed countries.
2. The inherent tendency of FDI flows to move towards regions or states which are well endowed in terms of natural resources and availability of infrastructure has the potential to accentuate regional disparity. Foreign capital is also criticized for accentuating the already existing income inequalities in the host country.
3. In the context of developing countries, it is usually alleged that the inflow of foreign capital may cause the domestic governments to slow down its efforts to generate more domestic savings, especially when tax mechanisms are difficult to implement. If the foreign corporations are able to secure incentives in the form of tax holidays or similar provisions, the host country loses tax revenues.

4. Often, the foreign firms may partly finance their domestic investments by borrowing funds in the host country's capital market. This action can raise interest rates in the host country and lead to a decline in domestic investments through 'crowding-out' effect. Moreover, suppliers of funds in developing economies would prefer foreign firms due to perceived lower risks and such shifts of funds may divert capital away from investments which are crucial for the development needs of the country.

5. The expected benefits from easing of the balance of payments situation might remain unrealised or narrowed down due to the likely instability in the balance of payments and the exchange rate. Obviously, FDI brings in more foreign exchange, improves the balance of payments and raises the value of the host country's currency in the exchange markets. However, when imported inputs need to be obtained or when profits are repatriated, a strain is placed on the host country's balance of payments and the home currency leading to its depreciation. Such instabilities jeopardize long-term economic planning. Foreign corporations also have a tendency to use their usual input suppliers which can lead to increased imports. Also, large scale repatriation of profits can be stressful on the balance of payments.

6. Jobs that require expertise and entrepreneurial skills for creative decision making may generally be retained in the home country and therefore the host country is left with routine management jobs that demand only lower levels of skills and ability. The argument of possible human resource development and acquisition of new innovative skills through FDI may not be realized in reality.

7. High profit orientation of foreign direct investors tend to promote a distorted pattern of production and investment such that production could get concentrated on items of elite and popular consumption and on non-essential items.

8. Foreign entities are usually accused of being anti-ethical as they frequently resort to methods like aggressive advertising and anticompetitive practices which would induce market distortions.

9. A large foreign firm with deep pockets may undercut a competitive local industry because of various advantages (such as in technology) possessed by it and may even drive out domestic firms from the industry resulting in serious problems of displacement of labour. The foreign firms may also exercise a high degree of market power and exist as monopolists with all the accompanying disadvantages of monopoly. The high growth of wages in

foreign corporations can influence a similar escalation in the domestic corporations which are not able to cover this increase with growth of productivity. The result is decreasing competitiveness of domestic companies which might prove detrimental to the long term interests of industrial development of the host country.

10. FDI usually involves domestic companies 'off –shoring', or shifting jobs and operations abroad in pursuit of lower operating costs and consequent higher profits. This has deleterious effects on employment potential of home country.
11. The continuance of lower labour or environmental standards in host countries is highly appreciated by the profit seeking foreign enterprises. This is of great concern because efforts to converge such standards often fail to receive support from interested parties.
12. At times, there is potential national security considerations involved when foreign firms function in the territory of the host country, especially when acute hostilities prevail.
13. FDI may have adverse impact on the host country's commodity terms of trade (defined as the price of a country's exports divided by the price of its imports). This could occur if the investments go into production of export goods and the country is a large country in the sale of its exports. Thus, increased exports drive down the price of exports relative to the price of imports.
14. FDI is also held responsible by many for ruthless exploitation of natural resources and the possible environmental damage.
15. With substantial FDI in developing countries there is a strong possibility of emergence of a dual economy with a developed foreign sector and an underdeveloped domestic sector.
16. Perhaps the most disturbing of the various charges levied against foreign direct investment is that a large foreign investment sector can exert excessive amount of power in a variety of ways so that there is potential loss of control by host country over domestic policies and therefore the less developed host country's sovereignty is put at risk. Mighty multinational firms are often criticized of corruption issues, unduly influencing policy making and evasion of corporate social responsibility.

No general assessment can be made regarding whether the benefits of FDI outweigh the costs. Each country's situation and each firm's investment must be examined in the light of various considerations and a judgment about the desirability or otherwise of the investment should be arrived at.

Many safeguards and performance requirements are put in place by developed and developing countries to improve the ratio of benefits to costs associated with foreign capital. A few examples are: domestic content requirements on inputs, reservation of certain key sectors to domestic firms, requirement of a minimum percent of local employees, ceiling on repatriation of profits, local sourcing requirements and stipulations for full or partial export of output to earn scarce foreign exchange.

5.9 FOREIGN DIRECT INVESTMENT IN INDIA (FDI)

The import-substitution strategy of industrialisation followed by India post independence stressed on an extremely careful and selective approach while formulating FDI policy. Extensive controls imposed by the government severely restricted the inflow of foreign capital to India. The enactment of the Foreign Exchange Regulation Act (FERA), 1973 consolidated the regulatory framework with stipulations of upto 40 per cent of foreign equity holding in a joint venture. The Industrial Policy announcements of 1980 and 1982 and the Technology Policy Statement (1983) provided for a moderately lenient attitude towards foreign investments by endorsement of manufacturing exports as well as modernisation of industries through liberalised imports of capital goods and technology. This was supplemented by trade liberalisation measures in the form of tariff reduction and shifting of large number of items from import licensing to Open General Licensing (OGL).

The most important shift in investment policy occurred when India embarked upon economic liberalisation and reforms programme in 1991 to raise its growth potential and to integrate it with the world economy. Further reforms in subsequent years put in place a series of measures directed towards liberalizing foreign investments and for ensuring access to foreign technology and funding.

The government's strategy favouring foreign investments and the prevalent robust business environment have ensured that foreign capital keeps flowing into the country. The government initiatives such as automatic approval of FDI, simplification of procedures, setting up of Foreign Investment Promotion Board (FIPB abolished wef May 2017), signing of the Multilateral Investment Guarantee Agency Protocol for protection of foreign investments, permitting use of foreign trade marks and brand names, 100% FDI in multitude of sectors , enactment of Foreign Exchange Management Act (FEMA), passing of the SEZ Act in 2005, Special

Economic Zones (SEZ), support to mergers ,acquisitions and green field investments, and encouragement to foreign technology collaboration agreements are a few such measures.

Apart from being a critical driver of economic growth, foreign direct investment (FDI) is a major source of non-debt financial resource for the economic development of India. According to United Nations Conference on Trade and Development (UNCTAD)'s World Investment Report 2016, India ranks as the tenth highest recipient of foreign direct investment globally in 2015 receiving $44 billion of investment that year compared to $35 billion in 2014. India has also moved up by one rank to become the sixth most preferred investment destination.

According to the Department of Industrial Policy and Promotion (DIPP), the total FDI investments India received during April - September 2016 rose 30 per cent year-on-year to US$ 21.6 billion. During the period, the services sector attracted the highest FDI equity inflow (US$ 5.29 billion), followed by telecommunications (US$ 2.79 billion), and trading (US$ 1.48 billion). Also, India received the maximum FDI equity inflows from Mauritius (US$ 5.85 billion) followed by Singapore, Netherlands, Japan and the USA.

With the government taking steps to improve the ease of doing business and to relax regulations, foreign direct investment into the country surged by 60 per cent to $4.68 billion in November 2016 from $2.93 billion in November 2015.

Currently, an Indian company may receive foreign direct investment either through 'automatic route' without any prior approval either of the Government or the Reserve Bank of India or through 'government route' with prior approval of the Government.

An Indian Company can receive foreign investment by issue of 'FDI compliant instruments' namely: equity shares, fully and mandatorily convertible preference shares and debentures, partly paid equity shares and warrants. These have to be issued in accordance with the provisions of the Companies Act, 2013 and the SEBI guidelines, as applicable.

All foreign investments are repatriable (net of applicable taxes) except in cases where the investment is made or held on non-repatriation basis or where the sectoral condition specifically mentions non-repatriation. Further, dividends/ profits (net of applicable taxes), on foreign investments, being current income can be remitted outside India through an Authorised Dealer bank. Only NRIs are allowed to set up partnership/ proprietorship concerns in India on non-repatriation basis.

In India, foreign investment is prohibited in the following sectors:

(i) Lottery business including Government / private lottery, online lotteries, etc.

(ii) Gambling and betting including casinos etc.

(iii) Chit funds

(iv) Nidhi company

(v) Trading in Transferable Development Rights (TDRs)

(vi) Real Estate Business or Construction of Farm Houses

(vii) Manufacturing of cigars, cheroots, cigarillos and cigarettes, of tobacco or of tobacco substitutes

(viii) Activities / sectors not open to private sector investment e.g. atomic energy and railway operations (other than permitted activities).

Foreign technology collaboration in any form including licensing for franchise, trademark, brand name, management contract is also prohibited for lottery business and gambling and betting activities.

With the objective of making India the most open economy in the world for FDI and for providing major impetus to employment and job creation, the FDI regime was radically liberalized on 20-June-2016. Changes introduced in the FDI policy include increase in sectoral caps, bringing more activities under automatic route and easing of conditions for foreign investment. These include easing of FDI in defence sector, e-commerce, in respect of food products manufactured or produced in India, pharmaceuticals (Greenfield and Brownfield), airports (both Greenfield and Brownfield),airport transport services, private security agencies, animal husbandry, establishment of branch offices, liaison office or project office, teleports, direct to home cable networks, mobile TV and headend-in-the sky broadcasting service and single brand retail trading.

5.10 OVERSEAS DIRECT INVESTMENT BY INDIAN COMPANIES

Integration of the Indian economy with the rest of the world is evident not only in terms of higher level of FDI inflows but also in terms of increasing level of FDI outflows as overseas investments by the Indian entrepreneurs in joint ventures (JV) and wholly owned subsidiaries (WOS). Outbound investments from India have undergone substantial changes not only in terms of size but also in terms of geographical spread and sectoral composition. Outward Foreign Direct Investment (OFDI) from India stood at US$ 1.86 billion in the month of June, 2016.

The overseas investments have been primarily driven by resource seeking, market seeking or technology seeking motives. Many Indian IT firms like Tata Consultancy Services, Infosys, WIPRO, and Satyam acquired global contracts and established overseas offices in developed economies to be close to their key clients. Of late, there has been a surge in resource seeking overseas investments by Indian companies, especially to acquire energy resources in Australia, Indonesia and Africa. Indian entrepreneurs are also choosing investment destinations in countries such as Mauritius, Singapore, British Virgin Islands, and the Netherlands on account of higher tax benefits they provide.

At present, any Indian investor can make overseas direct investment in any bona-fide activity except in certain real estate activities. This has been made possible by progressive relaxation of the capital controls and simplification of procedures for outbound investments from India. For example, the annual overseas investment ceiling to establish joint ventures (JV) and wholly owned subsidiaries has been raised to US$ 125,000 from US$ 75,000. The RBI has also relaxed norms for foreign investment by Indian corporates by raising the borrowing limit.

Policies in respect of foreign investments undergo far reaching changes from time to time. (Learners are expected to keep pace with the modifications in government policy in respect of inbound and outbound foreign investments).

SUMMARY

- Foreign capital may flow into an economy in different ways, such as foreign aid, grants, borrowings, deposits from non-resident Indians, investments in the form of foreign portfolio investment (FPI) and foreign direct investment (FDI)
- Foreign direct investment is defined as a process whereby the resident of one country (i.e. home country) acquires ownership of an asset in another country (i.e. the host country) and such movement of capital involves ownership, control as well as management of the asset in the host country.
- Direct investments are real investments in factories, assets, land, inventories etc. and have three components, viz., equity capital, reinvested earnings and other direct capital in the form of intra-company loans. FDI may be categorized as horizontal, vertical or conglomerate.
- Foreign portfolio investment is the flow of 'financial capital' with stake in a firm at below 10 percent, and does not involve manufacture of goods or provision of services, ownership management or control of the asset on the part of the investor.
- The main reasons for foreign direct investment are profits, higher rate of return,

possible economies of large-scale operation, risk diversification, retention of trade patents, capture of emerging markets, lower host country environmental and labour standards, bypassing of non tariff and tariff barriers, cost–effective availability of needed inputs and tax and investment incentives.

- Foreign direct investment takes place through opening of a subsidiary or associate company, equity injection, acquiring a controlling interest, mergers and acquisitions (M&A), joint venture and green field investment.
- Benefits of foreign direct investment include positive outcomes of competition such as cost- reducing and quality-improving innovations, higher efficiency, huge variety of better products and services at lower prices, welfare for consumers, multiplier effects on employment, output and income, relatively higher wages, better access to foreign markets, control of domestic monopolies and betterment of balance of payments position.
- Potential problems of foreign direct investment include use of inappropriate capital- intensive methods in a labour-abundant country, increase in regional disparity, crowding-out of domestic investments, diversion of capital resulting in distorted pattern of production and investment, instability in the balance of payments and exchange rate and indiscriminate repatriation of the profits.
- FDIs are also likely to indulge in anti-ethical market distortions, off–shoring or shifting of jobs, overexploitation of natural resources causing environmental damage, exercising monopoly power, decrease competitiveness of domestic companies, potentially jeopardize national security and sovereignty, worsen commodity terms of trade and cause emergence of a dual economy
- FDI in India, mostly a post reform phenomenon, is a major source of non-debt financial resource for economic development. The government has, at different stages, liberalized FDI by increasing sectoral caps, bringing in more activities under automatic route and easing of conditions for foreign investment.
- Overseas direct investments by Indian companies, made possible by progressive relaxation of capital controls and simplification of procedures for outbound investments from India, have undergone substantial changes in terms of size, geographical spread and sectoral composition. Outward Foreign Direct Investment (OFDI) from India stood at US$ 1.86 billion in the month of June 2016.

TEST YOUR KNOWLEDGE

I. Multiple Choice Type Questions

1. Which of the following statements is incorrect?

   (a) Direct investments are real investments in factories, assets, land, inventories etc. and involve foreign ownership of production facilities.

   (b) Foreign portfolio investments involve flow of 'financial capital'

   (c) Foreign direct investment (FDI) is not concerned with either manufacture of goods or with provision of services.

   (d) Portfolio capital moves to a recipient country which has revealed its potential for higher returns and profitability.

2. Which of the following is a component of foreign capital?

   (a) Direct inter government loans

   (b) Loans from international institutions (e.g. World Bank, IMF, ADB)

   (c) Soft loans for e.g. from affiliates of World Bank such as IDA

   (d) All the above

3. Which of the following would be an example of foreign direct investment from Country X?

   (a) A firm in Country X buys bonds issued by a Chinese computer manufacturer.

   (b) A computer firm in Country X enters into a contract with a Malaysian firm for the latter to make and sell to it processors

   (c) Mr. Z a citizen of Country X buys a controlling share in an Italian electronics firm

   (d) None of the above

4. Which of the following types of FDI includes creation of fresh assets and production facilities in the host country?

   (a) Brownfield investment

   (b) Merger and acquisition

   (c) Greenfield investment

(d) Strategic alliances

5. Which is the leading country in respect of inflow of FDI to India?

   (a) Mauritius

   (b) USA

   (c) Japan

   (d) USA

6. An argument in favour of direct foreign investment is that it tends to

   (a) promote rural development

   (b) increase access to modern technology

   (c) protect domestic industries

   (d) keep inflation under control

7. Which of the following is a reason for foreign direct investment?

   (a) secure access to minerals or raw materials

   (b) desire to capture of large and rapidly growing emerging markets

   (c) desire to influence home country industries

   (d) (a) and (b) above

8. A foreign direct investor

   (a) May enter India only through automatic route

   (b) May enter India only through government route

   (c) May enter India only through equity in domestic enterprises

   (d) Any of the above

9. Foreign investments are prohibited in

   (a) Power generation and distribution

   (b) Highways and waterways

   (c) Chit funds and Nidhi company

   (d) Airports and air transport

10. Which of the following statement is false in respect of FPI?
    (a) portfolio capital in general, moves to investment in financial stocks, bonds and other financial instruments about foreign portfolio investment?
    (b) is effected largely by individuals and institutions through the mechanism of capital market
    (c) is difficult to recover as it involves purely long term investments and the investors have controlling interest
    (d) investors also do not have any intention of exercising voting power or controlling or managing the affairs of the company

II. Short Answer Type Questions

1. What are the different types of foreign capital?
2. Define foreign direct investment?
3. Enumerate the components of foreign direct investment?
4. Distinguish between horizontal and vertical foreign direct investment
5. What is meant by foreign portfolio investment?
6. What are the different routes for securing FDI?
7. What is meant by automatic route?
8. Mention the effects of FDI on host country labour?
9. What are the reasons for the speculative nature of foreign portfolio investments?
10. What impact does FDI have on host country employment?
11. Outline the effect of FDI on technology of host country?
12. Enumerate the effect of FDI on domestic industries?
13. Do you think FDI would help prevent formation of monopolies?
14. Do you agree with the argument that FDI is likely to reduce employment?
15. What implications do FDI have on domestic resource use?
16. Why did India discourage FDIs in its early stages?

III. Long Answer Type Questions

1. What are the different types of foreign capital?

2. Define foreign direct investment (FDI). What are the features of FDI?
3. What are the characteristics of foreign portfolio investments (FPI)?
4. Describe the factors influencing foreign direct investments?
5. Enumerate the host country determinants of foreign direct investment?
6. What are the factors in the host country that discourage inflow of foreign investments?
7. Explain the different modes of effecting foreign direct investment (FDI)?
8. What are the benefits of foreign direct investments to the host country?
9. Critically examine the general arguments put forth against entry of foreign capital
10. Write a note on foreign direct investment in India
11. Give an account of overseas direct investments by Indian companies?
12. Distinguish between foreign direct investment and foreign institutional investment?
13. Elucidate the potential costs and benefits of foreign direct investment?
14. Explain the state of affairs of foreign direct investment in India
15. What are the grounds on which the opponents of foreign investments criticise the flow of FDI to developing countries?
16. Mention two arguments made in favour of FDI to developing economies like India? Illustrate your answer
17. Which are the sectors in India where FDI is prohibited? Why?
18. "Foreign capital is not a bag of unmixed blessings as far as its impact on the host country is concerned". Comment on this statement.

IV Application Oriented Questions

1. Which of the following is a FDI?

   (i) Claram Joe, a German investor buys 5000 shares of Ford, a US Automobile company.

   (ii) Annette D, the US Company acquires all the equity shares of Emeline & Co in Alice Land which makes computer components.

(iii) A Bulgarian investor Boryana Gergiev pays cash and buys 0.2 % of all outstanding equity shares of Mariette company which makes computer peripherals

(iv) Maansi Tech solutions purchase 52% stake in a Sarra, a Jamaican technology firm

(v) Kora extends a loan to Christa Victorine, a power producing firm in which it holds 60 percent of equity

(vi) Augusta Corp lends pounds 10 million to Lee Sud, a Dutch parts making firm in which it holds 79 percent of equity

(vii) Labour group in your country oppose the flow of FDI into the country on grounds of perceived inequities consequent on FDI. What are their arguments?

(viii) Beth & Sushil are members of the committee for resolution of the issue cited under What arguments would they put forth to convince the labour groups of the welfare implications for labour that may arise from FDI?

ANSWERS/HINTS

I Multiple Choice Type Questions

1. (c) **2.** (d) **3.** (c) **4.** (c) **5.** (a) **6** (b) **7.** (d) **8.** (d) **9.** (c) **10.** (c)

II Short Answer Type Questions

1. Foreign aid or assistance, multilateral aid from international organizations like the World Bank, borrowings of all types; such as, soft loans, external commercial borrowings, deposits from NRIs, and investments both FPI and FDI.

2. All investments involving a long term relationship and reflecting a lasting interest and control of a resident entity in one economy in an enterprise resident in an economy other than that of the direct investor and occur through acquisition of more than 10 percent of the shares of the target asset.

3. FDI has three components, viz., equity capital, reinvested earnings and other direct capital in the form of intra-company loans.

4. A horizontal direct investment is said to take place when the investor establishes the same type of business operation in a foreign country as it operates in its home country, whereas a vertical investment is one under which the investor establishes or acquires a business activity in a foreign

country which is different from the investor's main business activity, yet in some way supplements its major activity.

5. Foreign portfolio investment is the flow of 'financial capital' rather than 'real capital' and does not involve ownership, control, or management on the part of the investor.

6. The main forms of direct investments are: the opening of overseas companies, including the establishment of subsidiaries or branches, creation of joint ventures on a contract basis, joint development of natural resources and purchase or annexation of companies in the country receiving foreign capital.

7. Direct investments through 'automatic route' do not need any prior approval either of the Government or of the Reserve Bank of India.

8. Benefits of higher wages, better opportunities for employment and skill enhancement, increased productivity, adverse effects of displacement due to use of capital intensive methods, crowding in jobs requiring low skills, perpetuation of low labour standards and differential treatment.

9. Typically of short term nature with no intention to create capital assets; tendency to often speedily shift the capital from one country to another with changes in prospects of returns.

10. Better opportunities for employment, likely to concentrate in less skill requiring jobs, possible displacement due to use of capital intensive methods

11. Possible state-of-the-art technology transfer, improvement in host country technology (may be inappropriate for a labour abundant nation). Often criticized of transferring outdated technology

12. Unequal competition, gainfully outperforms the host country's domestic firms, tendency to undercut a competitive local industry, may even drive out domestic firms from the industry, exercise a high degree of market power and exist as monopolists, high growth of wages in foreign corporations can influence a similar escalation in the domestic corporations, decreasing competitiveness, detrimental to the long term interests.

13. Increased competition decreases market power and the chance of formation of monopolies. However, foreign firms may also act as monopolists.

14. Possible due to capital intensive technology which is inappropriate for a labour abundant country; displacement of labour if industries fail or are forced to close down

15. Better and more efficient utilization of available resources, but resources are likely to be unsustainably overexploited causing environmental damage.

16. Policy of import substitution, extensive controls, selective policy

IV Application Oriented Questions

(i) Not FDI because less than 10 percent (which is the globally accepted criterion)

(ii) FDI since 100 percent shares are bought

(iii) Not FDI because an insignificant part of the total stake is acquired

(iv) FDI because it involves more than 10 percent of the company's shares.

(v) FDI; lending to a company in which Kora has majority stake

(vi) FDI refer (e)above

(vii) Foreign corporates concentrate on capital-intensive methods of production - so they need to hire only relatively few workers, technology inappropriate for a labour-abundant country - does not support generation of jobs or address poverty and unemployment- help accentuate the already existing income inequalities- jobs that require expertise and entrepreneurial skills for creative decision making may generally be retained in the home country and therefore the host country is left with routine management jobs that demand only lower levels of skills and ability. The argument of possible human resource development and acquisition of new innovative skills through FDI may not be realized in reality- may resort to anti-ethical, and anticompetitive practices- 'off –shoring', or shifting jobs – negative effects on employment potential of home country- continuance of lower labour or environmental standards and ruthless labour and natural resources exploitation.

(viii) FDI will - accelerate growth and foster economic development – bring in technological know-how, management skills and marketing methods- generate direct employment in the recipient country- Subsequent FDI as well as domestic investments propelled in the downstream and upstream projects that come up in multitude of other services generate multiplier effects on employment and income - generate indirect employment opportunities-- promote relatively higher wages for skilled jobs- more indirect employment will be generated to persons in the lower-end services sector occupations thereby catering to an extent even to the less educated and unskilled engaged in those units. Better work culture and higher productivity standards- induce productivity related awareness and may also contribute to overall human resources development.