INTERNATIONAL BUSINESS AND TRADE

UNIT-5

PART-II

Foreign Direct Investment (FDI)

Any investment from an individual or firm that is located in a foreign country into a country is called Foreign Direct Investment.

- Generally, FDI is when a foreign entity acquires ownership or controlling stake in the shares of a company in one country, or establishes businesses there.
- It is different from foreign portfolio investment where the foreign entity merely buys equity shares of a company.
- In FDI, the foreign entity has a say in the day-to-day operations of the company.
- FDI is not just the inflow of money, but also the inflow of technology, knowledge, skills and expertise/know-how.
- It is a major source of non-debt financial resources for the economic development of a country.
- FDI generally takes place in an economy which has the prospect of growth and also a skilled workforce.
- FDI has developed radically as a major form of international capital transfer since the last many years.
- The advantages of FDI are not evenly distributed. It depends on the host country's systems and infrastructure.
- The determinants of FDI in host countries are:
    - Policy framework
    - Rules with respect to entry and operations/functioning (mergers/acquisitions and competition)
    - Political, economic and social stability

- Treatment standards of foreign affiliates
- International agreements
- Trade policy (tariff and non-tariff barriers)
- Privatisation policy

Foreign Direct Investment (FDI) in India – Latest update

1. From April to August 2020, total Foreign Direct Investment inflow of USD 35.73 billion was received. It is the highest ever for the first 5 months of a financial year. FDI inflow has increased despite Gross Domestic Product (GDP) growth contracted 23.9% in the first quarter (April-June 2020).
2. FDI received in the first 5 months of 2020-21 (USD 35.73 billion) is 13% higher as compared to the first five months of 2019-20 (USD 31.60 billion).

FDI in India

The investment climate in India has improved tremendously since 1991 when the government opened up the economy and initiated the LPG strategies.

- The improvement in this regard is commonly attributed to the easing of FDI norms.
- Many sectors have opened up for foreign investment partially or wholly since the economic liberalization of the country.
- Currently, India ranks in the list of the top 100 countries in ease of doing business.
- In 2019, India was among the top ten receivers of FDI, totalling **$49 billion inflows**, as per a UN report. This is a 16% increase from 2018.
- In February 2020, the DPIIT notifies policy to allow 100% FDI in insurance intermediaries.
- In April 2020, the DPIIT came out with a new rule, which stated that the entity of nay company that shares a land border with India or where the beneficial owner of investment into India is situated in or is a citizen of such a country can invest only under the Government route. In other words, such entities can only invest following the approval of the Government of India

- In early 2020, the government decided to sell a 100% stake in the national airline's Air India. Find more about this in the video below:

FDI Routes in India

There are three routes through which FDI flows into India. They are described in the following table:

Category 1	**Category 2**	**Category 3**
100% FDI permitted through **Automatic Route**	Up to 100% FDI permitted through **Government Route**	Up to 100% FDI permitted through **Automatic + Government Route**

Automatic Route FDI

In the **automatic route**, the foreign entity does not require the prior approval of the government or the RBI.

Examples:

- Medical devices: up to 100%
- Thermal power: up to 100%
- Services under Civil Aviation Services such as Maintenance & Repair Organizations
- Insurance: up to 49%
- Infrastructure company in the securities market: up to 49%
- Ports and shipping
- Railway infrastructure

- Pension: up to 49%
- Power exchanges: up to 49%
- Petroleum Refining (By PSUs): up to 49%

Government Route FDI

Under the **government route**, the foreign entity should compulsorily take the approval of the government. It should file an application through the Foreign Investment Facilitation Portal, which facilitates single-window clearance. This application is then forwarded to the respective ministry or department, which then approves or rejects the application after consultation with the DPIIT.

Examples:

- Broadcasting Content Services: 49%
- Banking & Public sector: 20%
- Food Products Retail Trading: 100%
- Core Investment Company: 100%
- Multi-Brand Retail Trading: 51%
- Mining & Minerals separations of titanium bearing minerals and ores: 100%
- Print Media (publications/printing of scientific and technical magazines/speciality journals/periodicals and a facsimile edition of foreign newspapers): 100%
- Satellite (Establishment and operations): 100%
- Print Media (publishing of newspaper, periodicals and Indian editions of foreign magazines dealing with news & current affairs): 26%

Sectors where FDI is prohibited

There are some sectors where any FDI is completely prohibited. They are:

- Agricultural or Plantation Activities (although there are many exceptions like horticulture, fisheries, tea plantations, Pisciculture, animal husbandry, etc.)
- Atomic Energy Generation
- Nidhi Company
- Lotteries (online, private, government, etc.)
- Investment in Chit Funds
- Trading in TDR's
- Any Gambling or Betting businesses
- Cigars, Cigarettes, or any related tobacco industry
- Housing and Real Estate (except townships, commercial projects, etc.)

New FDI Policy

According to the new FDI policy, an entity of a country, which shares a land border with India or where the beneficial owner of investment into India is situated in or is a citizen of any such country, can invest only under the Government route.

A transfer of ownership in an FDI deal that benefits any country that shares a border with India will also need government approval.

Investors from countries not covered by the new policy only have to inform the RBI after a transaction rather than asking for prior permission from the relevant government department.

The earlier FDI policy was limited to allowing only Bangladesh and Pakistan via the government route in all sectors. The revised rule has now brought companies from China under the government route filter.

Benefits of FDI

FDI brings in many advantages to the country. Some of them are discussed below.

1. Brings in financial resources for economic development.
2. Brings in new technologies, skills, knowledge, etc.
3. Generates more employment opportunities for the people.

4. Brings in a more competitive business environment in the country.
5. Improves the quality of products and services in sectors.

Disadvantages of FDI

However, there are also some disadvantages associated with foreign direct investment. Some of them are:

1. It can affect domestic investment, and domestic companies adversely.
2. Small companies in a country may not be able to withstand the onslaught of MNCs in their sector. There is the risk of many domestic firms shutting shop as a result of increased FDI.
3. FDI may also adversely affect the exchange rates of a country.

Government Measures to increase FDI in India

1. Government schemes like production-linked incentive (PLI) scheme in 2020 for electronics manufacturing, have been notified to attract foreign investments.
2. In 2019, the amendment of FDI Policy 2017 by the government, to permit 100% FDI under automatic route in coal mining activities enhanced FDI inflow.
3. FDI in manufacturing was already under the 100% automatic route, however, in 2019, the government clarified that investments in Indian entities engaged in contract manufacturing is also permitted under the 100% automatic route provided it is undertaken through a legitimate contract.
4. Further, the government permitted 26% FDI in digital sectors. The sector has particularly high return capabilities in India as favourable demographics, substantial mobile and internet penetration, massive consumption along technology uptake provides great market opportunity for a foreign investor.
5. Foreign Investment Facilitation Portal (FIFP) is the online single point interface of the Government of India with investors to facilitate FDI. It is administered by the Department for Promotion of Industry and Internal Trade, Ministry of Commerce and Industry.
6. **FDI inflow is further expected to increase –**

- as foreign investors have shown interest in the government's moves to allow private train operations and bid out airports.
- Valuable sectors such as defence manufacturing where the government enhanced the FDI limit under the automatic route from 49% to 74% in May 2020, is also expected to attract large investments going forward.

Regulatory Framework for FDI in India

In India, there are several laws regulating FDI inflows. They are:

- Companies Act
- Securities and Exchange Board of India Act, 1992 and SEBI Regulations
- Foreign Exchange Management Act (FEMA)
- Foreign Trade (Development and Regulation) Act, 1992
- Civil Procedure Code, 1908
- Indian Contract Act, 1872
- Arbitration and Conciliation Act, 1996
- Competition Act, 2002
- Income Tax Act, 1961
- Foreign Direct Investment Policy (FDI Policy)

Important Government Authorities in India concerning FDI

- Foreign Investment Promotion Board (FIPB)
- Department for Promotion of Industry and Internal Trade (DPIIT)
- Reserve Bank of India (RBI)
- Directorate General of Foreign Trade (DGFT)
- Ministry of Corporate Affairs, Government of India
- Securities and Exchange Board of India (SEBI)
- Income Tax Department

- Several Ministries of the GOI such as Power, Information & Communication, Energy, etc.

Way Forward with FDI

1. FDI is a major driver of economic growth and an important source of non-debt finance for the economic development of India. A robust and easily accessible FDI regime, thus, should be ensured.
2. Economic growth in the post-pandemic period and India's large market shall continue to attract market-seeking investments to the country.

What was the FDI in the year 2020?

As of July 2020, the Foreign Direct Investment in India totalled up to 3269 million.

Which country has the highest FDI in India?

Singapore emerged as the largest source of FDI in India during the last fiscal with $ 14.67 billion investments. It was followed by Mauritius ($ 8.24 billion), the Netherlands ($ 6.5 billion), the US ($ 4.22 billion), Caymen Islands ($ 3.7 billion), Japan ($ 3.22 billion), and France ($ 1.89 billion)

In which sector is Foreign Direct Investment prohibited?

The present policy prohibits FDI in the following sectors: Gambling and Betting. Lottery business (including government/ private lottery, online lotteries etc) Activities /sectors not open to private sector investment (eg, atomic energy /railways).

Which country has the highest FDI in the world?

The United States remained the largest recipient of FDI, attracting 1 billion in inflows, followed by China and Singapore.

Foreign direct investment or FDI is an investment made by a foreign entity (an individual or a company) into a business based in another country. FDI is characterized by a notion of direct control and is not simply the transfer of monetary funds. A lasting interest differentiates foreign direct investment from foreign portfolio investment.

<u>Methods of foreign direct investment</u>

There are many ways by which a foreign investor can make a foreign direct investment. Investors can expand their business in another country. They can also acquire voting stocks of a business based outside their country. Let us outline the ways in which investors can penetrate a foreign market through overseas direct investment.

- Mergers and Acquisitions
- Getting voting stocks in a business based in another country
- Joint ventures with firms based overseas
- Starting a subsidiary of a domestic firm in a foreign country

Types of foreign direct investment

There are mainly two types of FDI- Horizontal and Vertical, However, two other types of foreign direct investments have emerged- conglomerate and platform FDI.

1. **HORIZONTAL FDI:** under this type of FDI, a business expands its inland operations to another country. The business undertakes the same activities but in a foreign country.
2. **VERTICAL FDI:** in this case, a business expands into another country by moving to a different level of the supply chain. Thus business undertakes different activities overseas but these activities are related to the main business.
3. **CONGLOMERATE FDI:** under the type of FDI, a business undertakes unrelated business activities in a foreign country. This type is uncommon as in involves the difficulty of penetrating a new country and an entirely new market.
4. **PLATFORM FDI:** here, a business expands into another country but the output from the business is then exported to a third country.

After the liberalization of the economy in 1991, India opened its market to foreign investors. Over the years the government has taken several reforms in foreign direct investment norms in order to encourage more overseas investor to invest in the country.

Apart from being a critical driver of economic growth, FDI also helps bring in more job opportunities, new technology, managerial expertise, and improved infrastructure. We at FDI India facilitate overseas direct investment by bridging the gap between foreign investors and investing opportunities in India.

Methods of Foreign Direct Investment (FDI)

There are many ways through which FDI is done. Here we will talk about the most prominent methods and types of Foreign direct investment. Methods of FDI can be divided into two broad categories – greenfield investments and brownfield investments.

When a company of a different country invests in the business of another country or want to expand their horizon in another country, two things become important. One is how they should build up their business or influence to generate enough revenue in a foreign country. And another is what would be the most profitable methods of FDI.

To understand this, let's look at two methods of FDI –

#1 – Greenfield Investments:

Many companies in foreign countries believe that they should start everything from scratch. If they become interested in FDI, they would build up their own factory in a different country, they would train people to work in their factory/organization, and they would try to provide offerings as per the culture of the country. We can take the example of McDonald and Starbucks. They both started everything from scratch and they are now the prominent brands in India. These are called greenfield investments.

#2 – Brownfield Investments:

This is a short-cut method of the previous method. In these methods of FDI, the foreign businesses don't take the pain of building up to something from scratch in another country. They expand their business by either going for cross-border **mergers and acquisitions**. Doing this allows them to start their heads-up right away without building anything from zero. The example of this is Tata Motors' acquisition of Jaguar. Tata Motors didn't need to build a new factory in the UK but started running the business from the existing factory of Jaguar.

Types of Foreign Direct Investment

There are two types of foreign direct investment. One is a horizontal foreign direct investment and another is the vertical foreign direct investment.

1 – Horizontal FDI

This is the most common types of foreign direct investment. In this case, a company merges with another company of another country to get stronger in the market and the products/services offered are of a homogeneous nature. It's done first to have a piece of market share in the foreign market and next to reduce competition.

2 – Vertical FDI

When a company of one country acquires or merges with another company of different country just to add more value to their value chain, it would be called vertical FDI. For example, if a company invests in a foreign company just to have a supplier producing raw materials for them, it would be a vertical FDI.

In these two types of Foreign Direct Investment, one thing is common. These FDI should be brownfield investments, because, for greenfield investments, everything is built from scratch.

Foreign Direct Investments can also be divided into another two types – inward FDI and outward FDI.

Inward FDI is invested in the local resources. And outward Foreign Direct Investment is defined as the investments made abroad that are thoroughly backed by the government.

Factors that Ensure Foreign Direct Investment

There are a series of factors that ensure that a foreign investor or an organization would be interested to invest in the business of another country. Let's have a quick look at these factors –

1. **Open Economy:** The first prerequisite of whether a foreign investor would be interested to invest in a business of another country is the type of economy the country runs. If it's a closed economy, it would be difficult for any foreign investor to invest in another business in the country. Foreign direct investments are made when the country has an open economy and the country has openness toward growth.
2. **Above-Average Growth Scenarios:** foreign investors won't be interested in a mature or saturated market. If a country is developing or developed but has room for above-average growth, the foreign direct investment would be made. Precisely, the businesses and the individuals that would like to make the FDI needs to see whether they have any growth prospects in the near future in a different country or not. If there's no growth prospect, why would anyone be interested?
3. **Skilled Workforce:** If we take the example of McDonald, we would be able to say that to expand to the developing country like India, they need a skilled workforce. The skilled workforce would be teachable; they should be having the basic skills of communication, technical expertise (if required), and the ability to learn. Without a skilled workforce, FDI won't be able to create any value.
4. **Government Support:** This is the most important aspect of all. If in a country, the government doesn't welcome FDI, the country won't receive any foreign direct investment. Since the foreign nationals need to go through a lot of convincing if the government doesn't support, they usually don't choose to invest in a country that discourages FDI.

Conclusion

Foreign direct investment can be defined as an investment done by an individual or an organization of one country into another organization/company of another country. This happens when an organization wants to expand into another country or want to have a 'lasting interest' in the company of another company.

Even if on the surface, it seems that FDI is quite good for developing countries, we should also pay heed to the disadvantages of Foreign Direct Investment as well.

One of the biggest disadvantages of Foreign Direct Investment is to let the foreign investors take ownership of the industries of a country that's strategically important to that particular country. The government should always ensure that the foreign investors should not get more than 10% of ownership in those industries that the country is quite good at.

It's true that it ensures that the businesses are well run, the global economy gets improved, and the investors also receive good returns on their investments. However, every country should think strategically about FDI before accepting it.