IMPLICATION OF ECONOMIC SLOWDOWN ON FDI INFLOWS TO INDIAN ECONOMY

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Abstract: This paper is based on the premises that how global economic slowdown has taken its toll on the foreign investment flows in the country as FDI has declined by a whopping 27.85% during the month of November 2008 this year over the same month a year ago.

FDI has been increasing over the past few years in the country. The share of FDI in total investment has more than doubled from 2.55 per cent in 2003-04 to 6.42 percent in 2006-07.

But a question that whether the ongoing inflows in India would be affected due to worldwide slowdown, it was difficult to assess the impact. This paper aims at analyzing the implications of economic slowdown on FDI inflow in India.

Under the liberalized economic environment, investment decision of investors is based on the macro-economic policy framework, investment climate in the host country, investment policies of the transnational corporation and other commercial considerations.

Keywords: FDI, Macroeconomy, UNCTAD, Global Recession, Liquidation, Indian Economy, Economic Slowdown, FIPB, DIPP, CCEA, Capex.

Introduction:

The year 2008 will mark the end of a growth cycle in international investment that started in 2004. During the period 2004-07, world foreign direct investment (FDI) flows reach a historic record of $1.8 trillion in 2007.

Due to the impact of the ongoing worldwide financial and economic crisis, FDI flows could decline by more than 20 per cent in 2008. A further decrease in FDI flows can be expected in 2009, as the full consequences of the crisis on transnational corporations' (TNCs)' investment expenditures will continue to unfold.

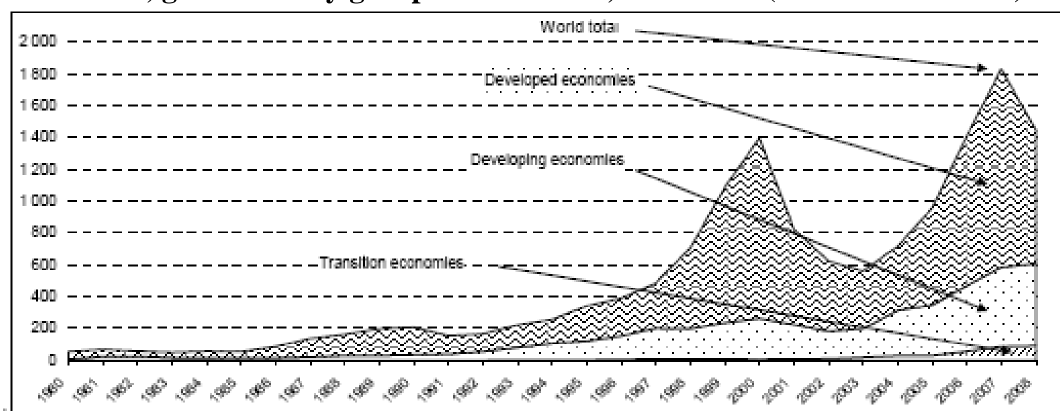
In the short term, the negative impact of the present economic recession on global FDI prospects should be the dominant one. Medium-term FDI prospects are more difficult to assess, due to the exceptional magnitude of the present crisis and to the fact that it could lead to major structural changes in the world economy. Nevertheless, some favourable factors for FDI growth are still at work, some of which are even a consequence of the crisis itself. Driving forces such as investment opportunities triggered by cheap asset prices and industry restructuring, large amounts of financial resources available in emerging countries, quick expansion of new activities such as new energies and environment-related industries, and a resilient trend in the internationalization of companies will presumably trigger, sooner or later, a new pickup in FDI flows.

Public policies will obviously play a major role in the implementation of favourable conditions for a quick recovery in FDI flows. Structural reforms aimed at ensuring more stability in the world financial system, renewed commitment to an open environment for FDI, the implementation of policies aimed at favoring investment and innovation are key issues in this respect. For effectively dealing with the crisis and its economic aftermath, it is important for policymakers to resist the temptation of quick-fix solutions or protectionism, and to maintain an overall favourable business and investment climate

A global economic slowdown is now projected and recession is already gripping a number of major developed economies. Industries likely to be especially affected are a number of manufacturing industries, including automobiles, aircraft, building materials, consumer goods, steel, and services such as IT enabled services, Construction etc.

FDI can decline by more than 20 per cent in 2008. In the face of the global economic slowdown (and recession in a number of major economies), tighter credit conditions and falling corporate profits, many companies have announced plans to curtail production, lay off workers and cut capital expenditure, all of which has implications for FDI. According to a preliminary estimate by UNCTAD, world FDI flows are expected to have declined in 2008 by 21 per cent due to a sharp step-back of flows during the last quarter of the year.

FDI inflows, global and by group of economies, 1980-2008 (Billions in Dollars)



Source :UNCTAD, based on FDI/TNC database (www.unctad.org/fdi statistics) and UNCTAD own estimates.

*1 UNCTAD World Investment report 2008

The crisis revealed structural weaknesses in the financial and corporate sectors of the affected countries, sparking fears that FDI flows to them would decline permanently, thus delaying the recovery and undermining the long-term growth potential of these countries.

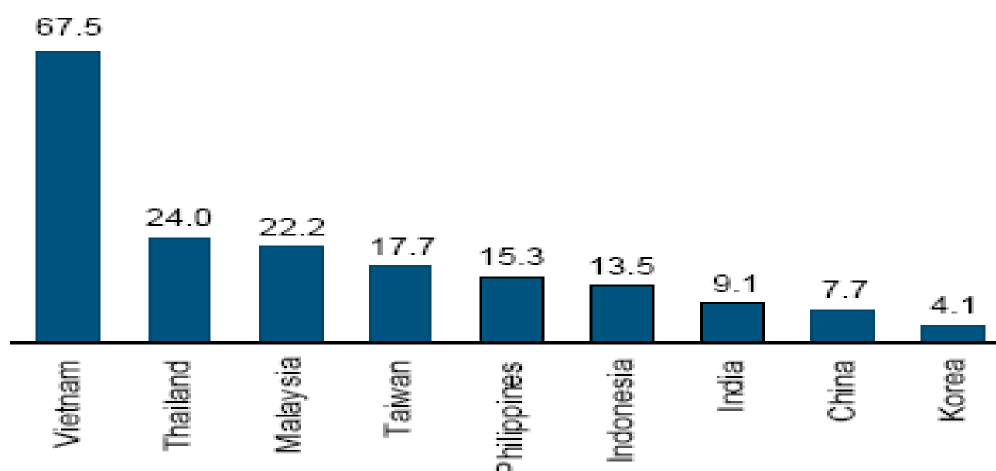
The openness of the Indian economies makes them particularly vulnerable to the global financial crisis. Risk aversion and the rapid evaporation of liquidity worldwide have already affected the region's asset markets, driving down equity prices, widening bond spreads and weakening currencies. The pain will be transmitted to the region's economies through two main channels: first, a sharp downturn in exports as shrinking loan availability dampens external demand; second, a drying-up of foreign liquidity which will cause a significant reduction in—if not a reversal of—external capital inflows.

Asia's high external vulnerability underlines the potential risk to its

economic growth. Would the waning appetite for risk and the increasing

liquidation of assets result in a flight of capital. Not all countries would be affected equally. The impact would vary, depending on each country's financial strength and its reliance on external funding. We analyze below key trends in capital flows to gauge how individual countries might be affected.

1 UNCATD World Investment report 2008



FDI matters to most Asian economies since it is an important part of total investment. The good news, however, is that the major economies—China, India and Korea—are considerably less vulnerable to a pullback of FDI. In fact, in China and Korea, FDI has become less crucial over the past decade as a funding source of domestic investment. The smaller ASEAN economies such as Thailand, Malaysia and the Philippines are more exposed and Vietnam, which has been flooded with foreign-funded investment projects over the past two years, is without doubt severely at risk,

How likely is the risk of a decline in FDI inflows? The question is important because FDI has a direct impact on real economic activity as foreign investment contributes to total fixed investment. FDI inflows, moreover, have important implications for technology transfers and productivity growth, particularly in emerging Asian economies.

How has the economic slowdown has impacted FDI flow to India is an issue examined in this paper. It documents the trends in FDI flows to the Indian economy in recent years, Relationship between GDP and FDI, Sector- wise impact of slowdown on FDI growth, the emerging policy environment toward FDI, and finally pulls together key conclusions

Policy on Foreign Direct Investment:

India has among the most liberal and transparent policies on FDI among the emerging economies. FDI up to 100% is allowed under the automatic route in all activities/sectors except the following, which require prior approval of the Government:-

1. Sectors prohibited for FDI

2. Activities/items that require an industrial license

3. Proposals in which the foreign collaborator has an existing financial/technical collaboration in India in the same field

4. Proposals for acquisitions of shares in an existing Indian company in financial service sector and where Securities and Exchange Board of India (substantial acquisition of shares and takeovers) regulations, 1997 is attracted

5. All proposals falling outside notified sectoral policy/CAPS under sectors in which FDI is not permitted

Most of the sectors fall under the automatic route for FDI. In these sectors, investment could be made without approval of the central government. The sectors that are not in the automatic route, investment requires prior approval of the Central Government. The approval in granted by Foreign Investment Promotion Board (FIPB). In few sectors, FDI is not allowed.

After the grant of approval for FDI by FIPB or for the sectors falling under automatic route, FDI could take place after taking necessary regulatory approvals form the state governments and local authorities for construction of building, water, environmental clearance, etc.

Procedure under automatic route:

FDI in sectors/activities to the extent permitted under automatic route does not require any prior approval either by the Government or RBI. The investors are only required to notify the Regional Office concerned of RBI within 30 days of receipt of inward remittances and file the required documents with that office within 30 days of issue of shares of foreign investors.

Procedure under Government Approval:

FDI in activities not covered under the automatic route require prior government approval. Approvals of all such proposals including composite proposals involving foreign investment/foreign technical collaboration is granted on the recommendations of Foreign Investment Promotion Board (FIPB).

Application for all FDI cases, except Non-Resident Indian (NRI) investments and 100% Export Oriented Units (EOUs), should be submitted to the FIPB Unit, Department of Economic Affairs (DEA), Ministry of Finance.

Application for NRI and 100% EOU cases should be presented to SIA in Department of Industrial Policy and Promotion.

Prohibited Sectors:

The extant policy does not permit FDI in the following cases:

i. Gambling and betting

ii. Lottery Business

iii. Atomic Energy

iv. Retail Trading

v. Agricultural or plantation activities of Agriculture (excluding Floriculture,

Horticulture, Development of Seeds, Animal Husbandry, Pisiculture and Cultivation of Vegetables, Mushrooms etc., under controlled conditions and services related to agro and allied sectors) and Plantations (other than Tea Plantations)

Industrial Licensing:

With progressive liberalization and deregulation of the economy, industrial license is required in very few cases. Industrial licenses are regulated under the Industries (Development and Regulation) Act 1951. At present, industrial license is required only for the following: -

1.Industries retained under compulsory licensing
2.Manufacture of items reserved for small scale sector by larger units
3.When the proposed location attracts locational restriction

The following industries require compulsory license: -

I Alcoholics drinks

II Cigarettes and tobacco products

III Electronic aerospace and defense equipment

IV Explosives

V Hazardous chemicals such as hydrocyanic acid, phosgene, isocynates and di-isocynates of hydro carbon and derivatives

Data Collection:

The data collected for this study is primarily secondary in nature.The data for GDP has been searched from the 'Ministry of Finance' website and data for FDI has been collected from 'Department of Industrial Policy and Promotion' (DIPP) website.

As the paper also examines the FDI flow for specific sectors of economy, the data for specific industry growth figure has been collected from Economic survey, NASCOM, SAIM, Ministry of Power websites and data for sector wise FDI has been collected from DIPP website.

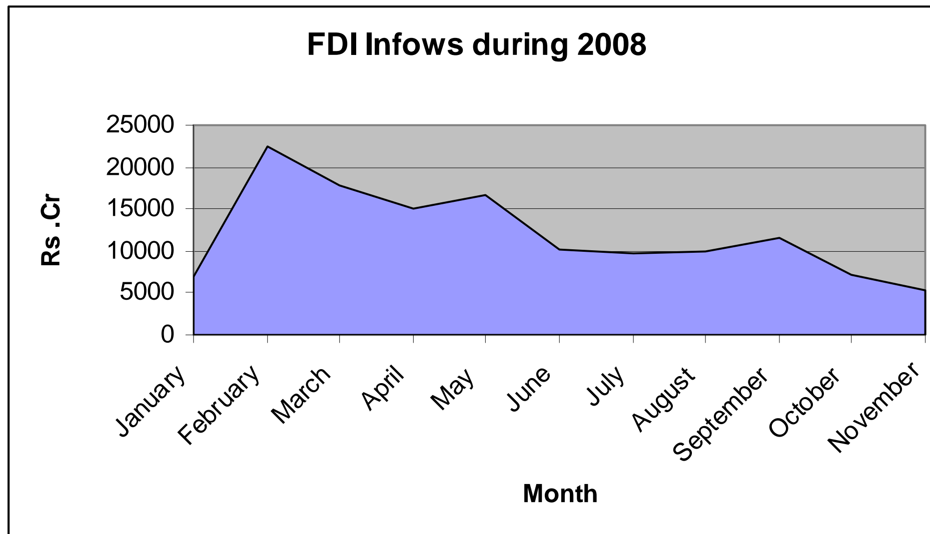
Research Methodology:

The paper attempts to find the relationship between GDP and FDI growth for India for the pre and post financial crises 2008 periods. Regression analysis was run on the annual GDP and FDI data explored through various secondary sources, for the period 1991 to IIIrd Qtr' 2009 and a significant positive correlation of 0.86 was found.

In order to analyze the slowdown impact more accurately, Regression Analysis was run on quarterly GDP and FDI data for the period of 2005 to 2009 III quarter. For similar period lagged regression analysis was also applied on the two sets of data.

The study also attempts to analyze the sector-wise FDI flow during this period. The correlation analysis was applied between the annual data of industry growth and Sector wise FDI growth for the period of 2006 to 2009 to find the affect of slowdown in specific sectors.

Findings:



FDI Inflows during 2008

Rs. Cr.	
January	6960
February	22529
March	17932
April	15005
May	16563
June	10244
July	9627
August	9995
September	11676
October	7284
November	5304
Total	128541

The above data shows that during the year 2008 FDI flow to India has shown a declining pattern since January'08 to November'08.

Foreign Direct Investment (FDI) inflows into the country dipped 26 per cent in this October at $1.49 billion, as compared to $2.02 billion in the same month a year ago.

Foreign equity inflows into the country had increased by 19.5 per cent in the same month last year. India may miss the $35 billion FDI target set for 2008-09. FDI inflows help bridge the current account deficit and slowdown in equity capital into the country would widen the deficit, thereby putting further pressure on Indian rupee. This is the first time FDI inflows dipped in 10 months.

The October FDI numbers come at a time when the Indian economy is facing headwinds arising out of the global financial meltdown. Foreign Institutional Investors have so far pulled out nearly $14 billion from Indian equity markets since January this year, as their parent companies are in need of liquidity.

Moreover, exports during the month had dipped over 12 per cent, the most in five years, while industrial production also dipped by 0.4 per cent in for the first time in the 15 years, as Indian factories cut down production on account of waning demand from both domestic and global markets.

Department of Industrial Policy and Promotion (DIPP) had proposed a series of measures for the consideration of the Union Cabinet to attract more FDI into India. Proposals include scaling up of FDI in single brand retail to 100 per cent, as well as allow 51 per cent FDI in multi-brand retail of electronics goods, computers, sports goods as well as watches.

Sector wise FDI Flow to India:

Amount Rupees in crores (US$ in million)

Ranks	Sector	2005-06 (April-March)	2006-07 (April-March)	2007-08 (April-March)	2008-09 (April – Nov.)	Cumulative Inflows (April '00 to Nov. '08)	% age to total Inflows (In terms of rupees)
1.	SERVICES SECTOR (financial & non-financial)	2,399 (543)	21,047 (4,664)	26,589 (6,615)	15,919 (3,600)	71,616 (16,658)	22 %
2.	COMPUTER SOFTWARE & HARDWARE	6,172 (1,375)	11,786 (2,614)	5,623 (1,410)	6,670 (1,543)	38,837 (8,820)	12 %
3.	TELECOMMUNICATIONS (radio paging, cellular mobile, basic telephone services)	2,776 (624)	2,155 (478)	5,103 (1,261)	9,231 (2,052)	25,978 (5,894)	8 %
4.	CONSTRUCTION ACTIVITIES (including roads & highways)	667 (151)	4,424 (985)	6,989 (1,743)	7,490 (1,767)	20,875 (4,930)	6 %
5.	HOUSING & REAL ESTATE	171 (38)	2,121 (467)	8,749 (2,179)	8,353 (1,941)	19,515 (4,652)	6 %
6.	AUTOMOBILE INDUSTRY	630 (143)	1,254 (276)	2,697 (675)	3,401 (782)	13,257 (3,019)	4 %
7.	POWER	386 (87)	713 (157)	3,875 (967)	2,467 (594)	12,097 (2,800)	4 %
8.	METALLURGICAL INDUSTRIES	6,540 (147)	7,866 (173)	4,686 (1,177)	3,420 (812)	10,769 (2,574)	3 %
9.	PETROLEUM & NATURAL GAS	64 (14)	401 (89)	5,729 (1,427)	947 (212)	9,193 (2,193)	3 %
10.	CEHMICALS (other than fertilizers)	1,731 (390)	930 (205)	920 (229)	1,991 (462)	8,132 (1,847)	2 %

The above data shows that service sector, software, and construction constitute the major proportion of total FDI flow to the Indian Economy. Therefore this paper has attempted to analyze specific impact in these sectors.

Correlation Analysis between Annual

GDP and FDI data during the period, Year 1991 to IIIrd Qtr'2009:

It seems reasonable to argue that due to current liquidity crises in the global economy discourage the foreign direct investment and thus discouraged foreign investors to invest in India.

Table – 1

Year		FDI		GDPFC
		CRORES		CRORES
1991-92		408		594168
1992-93		1094		681517
1993-94		2018		792150
1994-95		4312		925239
1995-96		6916		1083289
1996-97		9654		1260710
1997-98		13548		1401934
1998-99		12343		1616082
1999-00		10311		1786525
2000-01		12645		1925017
2001-02		19361		2097726
2002-03		14932		2261415
2003-04		12117		2538171
2004-05		17138		2877706
2005-06		24613		3275670
2006-07		70630		3790063
2007-08		98664		4303654
2008-09		85700		3635496

Correlation Results:

Coefficient of Correlation (r)	**0.861681**
Coefficient of Determination (r^2)	**0.742494**

Correlation results presented in Table 1 indicate a significant positive relationship between GDP and foreign direct investment during the period 1991 to 2009.

Correlation Analysis between Quarterly GDP and FDI during the period, Ist Qtr. 2005 to IIIrd Qtr. 2009:

Year	Quarter		GDPFC		FDI
			(Rs.crores)		(Rs.crores)
			782741		
2005-2006	I		749026		5165
	II		749159		4388
	III		884009		6841
	IV		893476		9040
2006-2007	I		860505		7820
	II		864860		12335
	III		1021996		21983
	IV		1042702		28492
2007-2008	I		990868		20228
	II		982968		9119
	III		1141973		21507
	IV		1187845		47421
2008-2009	I		783052		41812
	II		773687		31298
	III		873426		19215
	IV				
	Correlation				0.418002

Correlation Results:

Coefficient of Correlation (r) 0.418002
Coefficient of Determination (r^2) 0.174726

The above analysis again shows the positive relationship between Quarterly GDP and FDI data. Further on the same data set lagged correlation was also

done, on the premise that change in GDP in a given period will affect the FDI of next period. The results of the same are shown below.

Lagged Correlation Analysis between Quarterly GDP and FDI during the period, Ist Qtr. 2005 to IIIrd Qtr. 2009:

Lagged regression model

Year	Quarter		GDPFC (Rs. Cr.)		FDI (Rs. Cr.)
	IV		782741		
2005-2006	I		749026		5165
	II		749159		4388
	III		884009		6841
	IV		893476		9040
2006-2007	I		860505		7820
	II		864860		12335
	III		1021996		21983
	IV		1042702		28492
2007-2008	I		990868		20228
	II		982968		9119
	III		1141973		21507
	IV		1187845		47421
2008-2009	I		783052		41812
	II		773687		31298
	III				19215
	IV				
	correlation coeff.		0.703105		

Lagged Correlation Results:

Coefficient of Correlation r	0.703105
Coefficient of Determination r^2	0.494357

- **The degree of association is approx. 70% positive**
- **49% of the change in dependent variable (FDI) is explained by GDP**

How major sectors are affected during the slowdown: Empirical study:

Correlation between Industry Growth and FDI Growth during the slowdown period 2006-07 to 2008 -09:

Construction			
Year	Industry Growth	FDI (US $ In Million)	FDI Growth
2004-2005		152	
2005-06	16.2	151	-1%
2006-07	11.8	985	552%
2007-08	10.1	1743	77%
2008-09	6.5	1767	1%
	Correlation		0.824868

Power			
Year	Growth	FDI (US $ In Million)	FDI Growth
2004-2005		53	
2005-06	5.1	87	64%
2006-07	5.3	157	80%
2007-08	5.3	967	516%
2008-09	4.3	594	-39%
	Correlation		0.666068

Services			
Excluding (Community, social, Personal services)			
Year	Growth	FDI (US $ In Million)	FDI Growth
2004-2005		444	
2005-06	23.1	543	22%
2006-07	26.6	4664	759%
2007-08	24.1	6615	42%
2008-09	18.9	3600	-46%
	Correlation		0.811446

Automobiles			
Year	Production growth	FDI (US $ In Million)	FDI Growth
2004-2005		122	
2005-06		143	17%
2006-07	13.79	276	93%
2007-08	-2.29	675	145%
2008-09(Till Sept)	-94.69	782	16%
	Correlation		0.854023

Software			
Year	Revenue growth	FDI (US $ In Million)	FDI Growth
2004-2005		539	
2005-06	28.2	1375	155%
2006-07	37.4	2614	90%
2007-08	48	1410	-46%
2008-09	64	1543	9%
	Correlation		-0.49106

Summary:

Sector	Correlation Coefficient r	Coefficient of determination r^2
Construction	0.824868	0.680407
Power	0.666068	0.443647
Services	0.811446	0.658444
Automobile	0.854023	0.729356
Software	-0.49106	0.241136

Conclusion:

The key findings of this study can be summarized as:

- The correlation for the annual data on GDP and FDI for the period 1991 to 2009 which covers both pre and post financial crisis period shows a significant positive correlation of **0.861681**
- The correlation for the quarterly data on GDP and FDI for the period 2005 to 2009 which covers mainly post financial

crisis period shows a positive correlation of **0.418002**

- The lagged regression analysis run on the quarterly data on GDP and FDI for the period 2005 to 2009 which covers mainly post financial crisis period shows a strong positive correlation of **0.703105** through which we can conclude that GDP changes affects the FDI flows in the subsequent period in the same direction and the GDP can be considered as explanatory variable for FDI to the tune of **0.494357**
- The sector wise correlation between industry growth and FDI growth are as follows:

Sector	Correlation Coefficient	Coefficient of determination
Construction	**0.824868**	**0.680407**
Power	**0.666068**	**0.443647**
Services	**0.811446**	**0.658444**
Automobile	**0.854023**	**0.729356**
Software	**-0.49106**	**0.241136**

From the above we can observe that FDI flow to specific sectors is more strongly correlated to industry growth in service sector, Automobiles and construction.

Thus from the above findings, we can conclude that Economic slowdown has made a significant downward impact on FDI flow to India in general, and impact was found more profound in construction and service sector. Further the correlation is more significant in lagged regression analysis to the tune of 0.7 which imply that changes in GDP in a given period have more profound impact on FDI in the subsequent periods, rather than having an immediate impact.

The Emerging Policy Environment:

The Cabinet Committee on Economic Affairs (CCEA) in Feb 2009 adopted new guidelines for computation of foreign equity holding in Indian companies. Except in the case of 100% subsidiaries of majority foreign-owned/controlled Indian companies, where foreign investment will continue to be measured as of now, in all other companies, any notion of indirect or proportionate foreign holding has been done away with.

Under the new guidelines, downstream investments by an Indian company that has foreign investment but is "owned and controlled" by Indians will not be considered FDI.
"Owned" in this context will mean having a more than 50% shareholding and beneficial ownership.

"Controlled" means that the owners will have the power to appoint the majority of board directors and legally direct the board's actions. This means there is a huge opportunity for Indian-owned and –controlled companies to bring in FDI and then undertake downstream investments, without bothering about sect oral limits or restrictions.

However, if the investing Indian company is foreign-owned and

controlled, then its entire downstream investments will be considered indirect FDI. There is an exception. If the foreign-owned and controlled Indian company undertakes downstream investments in 100 per cent owned subsidiaries, the amount of indirect FDI will be equal to the percentage of foreign investment in the Indian company.

This will definitely help India to attract big-ticket FDI in sectors, which have been capped such as media, insurance, retail, telecom, real estate and even private banks. Positive for sectors with foreign investment caps, particularly - Aviation, Banking, Telecom, Media, Real estate, Insurance, Retail and much more.

Media sector to benefit immensely due to contentious issues of foreign investment limits for broadcasting, distribution and print and fund requirement for growth, which had translated into network of subsidiaries – Network18 group, Essel (Zee) group, and NDTV group.

Retail, in which FDI is only allowed in single-brand and wholesale cash and carry business, is likely to benefit to a great extent. Many foreign players currently operate through the franchisees. If foreign investments can be routed through Indian-owned and -controlled companies, overseas retailers will definitely like to be a part of this.

Telecom, sector with huge capex requirement, will benefit through sectoral FDI cap at 74%. Positive for foreign investors looking for higher control and investments in Indian operations – Bharti Airtel, Vodafone Essar, Idea Cellular, and Unitech Wireless.

In Insurance, this dispensation is already in place. In airports, the current investments in Mumbai and Delhi are significantly below the ceilings – this could help free up some additional limit. However, the effect can be minimal.

There is the Foreign Investment Promotion Board in India which is engage in considering and recommending inflow of those FDI which are not covered by the automatic route. This competent board under the office of the prime minister, is chaired by the Secretary Industry (Department of Industrial Policy & Promotion). Generally the inflow of FDI is permitted on the automatic route, excluding of the following areas-

- In those proposals where the foreign collaborator has already venture/tie up in Indian arena.
- Proposals which are connected with the acquiring of the shares in the present India company in favor of the foreign/non resident Indian/overseas corporate body investor.
- Those proposals which fall outside the notified sectoral policy/caps or under those sectors in which FDI cannot be allowed and/or when the investor has filed the application to the Foreign Investment Promotion Board and is not interested in availing the automatic route.

An important side effect of the crisis in all affected countries has been the further liberalization of FDI regimes, which has been encouraging. In light of

this, the future of FDI flows to the affected countries looks bright.

Limitations of the study:

- The availability of data has been a major constraint as data for industry growth was not available for longer periods therefore observations are based on limited data for specific sectors.

- The research paper analyzes the impact of economic slowdown represented by declining GDP on FDI flow to India. There may be other factors as well which have an implication on FDI.

- It is difficult to conclude that whether GDP affects FDI or it is a two way impact i.e. FDI also has implication for growth of GDP.

Scope for Further Research:

- Due to the time constraint we have analyzed the impact of slowdown on inward flow of FDI. While it may be equally interesting to find the impact of slowdown on outward FDI flow from India.
- Further research is needed for finding whether FDI affect GDP more strongly or it gets affected by GDP more strongly. A separate study can be undertaken in this direction.

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