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# A STUDY OF FOREIGN DIRECT AND PORTFOLIO INVESTMENTS IN INDIA

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## ABSTRACT

This paper attempts to study some of the emerging trends, issues and challenges in foreign investments in India focusing on Foreign Direct Investment (FDI) and Foreign Portfolio Investments (FPI). FPI inflows have been considerably volatile in the last few years as compared to FDI inflows. Further, policy initiatives taken to attract more FPI have not been successful in getting new portfolio investments. There has been overreliance on foreign investments focusing merely on getting new investments while ignoring necessary measures to retain the existing foreign investments. Moreover, certain structural and macroeconomic issues that affect investor sentiments have been overlooked. Based on these results, certain recommendations have been provided that can possibly boost investments in the country.

## I. Introduction

Capital is a crucial ingredient for economic growth. Since it may not possible for most nations to fulfil their capital requirements on their own, foreign investments are useful in plugging the saving investment gap. Two of the most important types of foreign investments are Foreign Direct Investments (FDI) and Foreign Portfolio Investments (FPI).

FDI is the category of international investment in which a resident entity in one country obtains a lasting interest in an enterprise resident in another country. The criteria used to distinguish direct investment from other types of investment is that “a direct investment is established when a resident in one economy owns 10 percent or more of the ordinary shares or voting power, for an incorporated enterprise, or the equivalent, for an unincorporated enterprise” (UNCTAD, 1999).

  

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A lasting interest means that there exists a long-term relationship between the investor and the enterprise. There is also some degree of influence by the investor on the management of the enterprise. On the other hand, FPI includes investments by a resident entity in one country in the equity and debt securities of an enterprise resident in another country which seek primarily capital gains and do not necessarily reflect a significant and lasting interest in the enterprise (UNCTAD, 1999).

India pursued an inward-looking policy post-independence for almost four decades, but after the country adopted the New Economic Policy in 1991, foreign investments have been encouraged as they act as a source of additional capital. Indeed, India has now become the 9th highest recipient of FDI in the world as per World Investment Report 2020.

India has been continuously trying to make foreign investment policy investor friendly by liberalising its policies in order to attract investments. In this paper, an attempt has been made to study the emerging recent trends of foreign investments in India focusing primarily on FDI and FPI and to identify some of the challenges in the policy landscape.

This paper has been divided into sections. Followed by the section on Introduction, Section 2 discusses FDI in a developing country perspective, Section 3 examines FDI in the Indian manufacturing sector, Section 4 presents the recent trends of FPI, followed by the Concluding Remarks given in Section 5.

## II. FDI: A Developing Country Perspective

The relationship between FDI and economic growth has received great attention from academic scholars and policy makers. A study based on a panel of 23 developing countries from 1978-1996 reveals that there exists a two-way relationship between FDI and economic growth (Basu, Chakraborty, & Reagle, 2003). The results showed that FDI inflows to a country and economic growth moved in the same direction in the long run. Another empirical study reveals that FDI flows may impede the economic growth in the short run, however, they are positively associated with economic growth in the long run. The results also emphasise that such positive impact of FDI with long run economic growth holds especially for the emerging and developing economies (Dinh, Wo, Anh, & Nguyen, 2019).

Undeniably, developing countries are an attractive destination for transnational companies. The availability of cheap skilled and unskilled labour has contributed to FDI inflows in developing countries. (Mallampaly & Sauvant, 1999). It is not only cost effective for Multinational

  

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Corporations (MNCs) to invest in developing countries, but it also gives them access to their huge markets. This preference for developing countries is also reflected in the global FDI trends.

Total FDI in the world fell down by 42% from US$1.5 trillion in 2019 to $859 billion in 2020. This decline was mostly borne by the developed countries, where the total FDI plummeted by 69% compared to the 12% decline witnessed by developing countries. Even before the world was struck by a pandemic, till 2019 the FDI inflows to the developed countries followed a downward trend while it remained fairly stagnant for the developing countries. Despite the fact that US remains the highest recipient of FDI inflows, at the aggregate level, developing countries surpass the total FDI inflow compared to the developed countries and constitute almost 70% of global FDI. China is the second largest recipient of FDI in the world and the largest amongst the developing countries (Investment Trends Monitor, 2021).

However, there is a caveat to such record high FDI inflows for developing countries. Even though overall FDI levels might appear robust in developing countries, green field FDI announcements fell by 46% (Investment Trends Monitor, 2021). Such a large decline is possibly an immediate outcome of the Covid-19 pandemic, reflecting negative investor sentiments and is most likely to have severe long run consequences. Greenfield investments create job opportunities, leads to capacity building and involves investment in new plant and machinery in the destination country. Fall in such investments would limit the ability of developing countries to invest in productive assets and infrastructure development. Such decline in investments is most likely to slow down the economic recovery of developing countries from the Covid-19 pandemic and adversely affect their GDP growth. This decline in greenfield investments would be an additional burden as these countries are already suffering from the adverse effects of the pandemic.

## III. FDI: The Indian Manufacturing Sector

In India, FDI increased by 13% in the year 2020 driven mostly by the digital sector. It appears to be significant given the downward trends of FDI inflows experienced by most other countries. It is also higher than the 4% increase witnessed by China, the largest recipient of FDI amongst developing countries. However, this increase in FDI inflows in India is primarily an outcome of mergers and acquisitions (Investment Trends Monitor, 2021) and are not greenfield investments. An increase in greenfield investments could add to the productive capacity of the country and also create new job opportunities. This could also address the problem of jobless growth persists. Thus, absolute FDI figures showing increase in FDI inflows can be quite deceptive. Such considerations must be not be overlooked for effective policy making.

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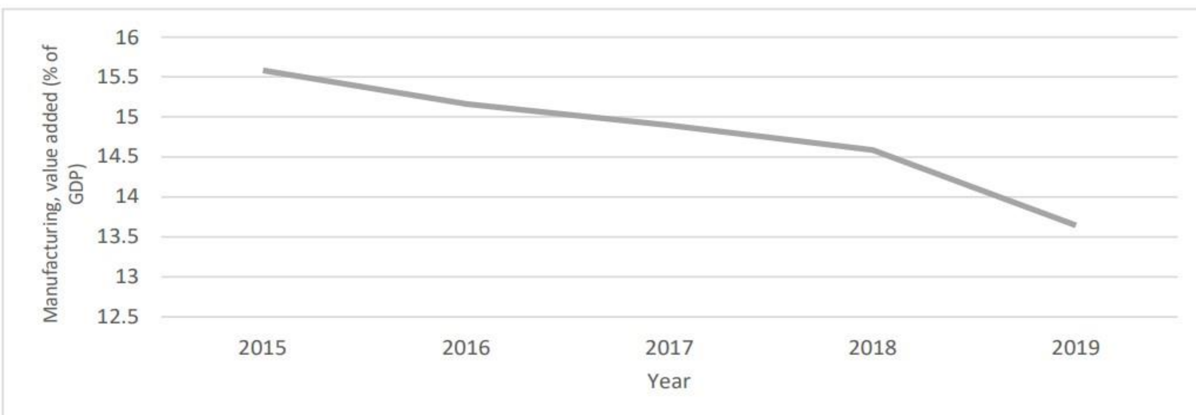
India has been continuously relaxing its FDI norms and now as high as 100% FDI is permitted for multiple sectors under the automatic and government route. One of the latest steps towards liberalising FDI norms is the announcement by the finance minister in this year's budget to increase the upper limit on foreign investments in the insurance sector from 49% to 74% (PIB, MoF, 2021).

In September 2014, the Make in India programme was announced. Attracting more FDI was one of the major goals of the programme that intended to boost domestic manufacturing in India (Make in India). It was envisioned that the move could increase manufacturing sector's contribution to GDP to 25% by 2025. If we look at figures from 2015 to 2019, there has not been any increase in manufacturing sector share of GDP so far. As it can be seen in the figure given below, it has remained almost stagnant ranging between 13.5%- 15.5%. In fact, a slight downward trend can be observed.

**Figure 1: Manufacturing, value added (% of GDP) from 2015-2019**




***Source: World Bank***

Most attempts to attract FDI have yet not had any drastic change in the Indian manufacturing sector as the sector continues to struggle. India has also failed to obtain sufficient FDI in lower end manufacturing as those investments went to countries like Bangladesh and Vietnam. Had such investments come to India, they could have created substantial production capacity and provided livelihood opportunities for many.

There is a possibility that there is weak targeting of factors that influence FDI transfers to developing countries. Even if there is relaxation in FDI norms, other factors such as contract enforcement, land acquisition laws, logistical costs, access to free trade areas and infrastructural

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support are key determinants of firms' investment decisions that may have been overlooked. Further, bureaucratic and administrative hurdles can also be major roadblocks in the establishment of manufacturing firms as any unwarranted delay due to these may add to the cost of doing business.

India has been trying to improve its Ease of Doing Business Rankings in order to attract FDI. It made a considerable improvement as it jumped 79 positions from 142 in 2014 to 63 in 2020 (World Bank, 2020). While improvement in Doing Business Indicators impacts FDI inflows or not is an entirely different field of research altogether, a closer look at the index reveals some of the structural issues within India that can impact businesses and investor sentiments. The Ease of Doing Business Index consists of ten sub-indices. The details are given in the table given below:

**Table 1: India's Ranking in Sub-Indices of Ease of Doing Business**

| Sub-Index | India's Ranking | Sub-Index | India's Ranking |
|---|---|---|---|
| Starting a Business | 136 | Protecting Minority Investors | 13 |
| Dealing with Construction Permits | 27 | Paying Taxes | 115 |
| Getting Electricity | 22 | Trading Across Borders | 68 |
| Registering Property | 154 | Enforcing Contracts | 163 |
| Getting Credit | 25 | Resolving Insolvency | 52 |

***Source: World Bank***

India ranks 163rd out of 190 countries in enforcing contracts. We are even behind countries like Venezuela in enforcing contracts which are crisis hit and suffer from massive political problems. In terms of starting a new business, we rank 136th and also the lowest amongst all South Asian countries. Even Afghanistan which has faced political turmoil for a long period of time fairs better than us in this sub-index. We rank 154th in the world in getting property registered. While the overall index may be questionable since it is taken after giving equal weightage to all the ten parameters, it does reveal some of the structural issues existing in India which highlight problems faced by investors that can deter foreign companies from starting new ventures in India. It can also explain why many companies engage in brownfield investments and mergers and acquisitions instead of greenfield investments.

Some scholars suggest that there is a trade-off between incentivising foreign investors to invest in India and promoting domestic investors. This is possible given that too much preference for FDI may be detrimental for domestic firms and local businesses. We may have been too keen on attracting FDI and focused too much on liberalising FDI norms for foreign investors. There is a

  

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need to work on grassroot problems as well such as hassles in registering property, enforcing contracts, land acquisition, infrastructure & logistical support amongst others to boost manufacturing and businesses. Improvements in these areas would benefit foreign and domestic firms alike. Such measures also help in cost reduction thereby improving the efficiency of firms. Foreign investments cannot automatically translate to production efficiencies. The ability of Indian manufacturing to gain from any kind of positive spill overs of FDI would be limited if the efficiency of the sector is not improved.

Further, an inquiry into the regional trends of FDI reveals that FDI inflows have been concentrated in some Indian states and a pattern of North-South divide can be seen. Some states such as Gujarat, Maharashtra, Karnataka, Tamil Nadu and Andhra Pradesh have received on an average much more FDI in the period from 2005-06 to 2018-2019 than other states such as Bihar, Madhya Pradesh, Rajasthan and Uttar Pradesh. (Saumya Bhowmick, 2020). There is an absence of favourable conditions in States that have been under-performing. The underperforming states significantly lack basic infrastructure support, developed input market, transport networks and communication. To attract FDI in these states, the need of the hour is to increase public investments in infrastructure and reduce logistical costs to create an environment conducive for private investment. Public investment does not always crowd out private investment and can actually pave the way for private investments including foreign investments.

Moreover, FDI numbers need to be studied with caution as there are some serious issues with the reported numbers of FDI inflows and it may undermine its relevance in policy analysis. Some of the primary sources of such distortions in data are delayed reporting, duplicate reporting, non-reporting, incorrect entries, notional flows, inappropriate industrial classification, inadequate representation of acquisitions and limited disclosure of the information obtained from investees (Rao & Dhar, 2018).

## IV. Foreign Portfolio Investments (FPI)

Foreign Portfolio Investments (FPI) are another form of foreign investments and are fundamentally different from FDIs. Portfolio investment includes investments by a resident entity in one country in the equity and debt securities of an enterprise in another country. These are intended primarily for capital gains and do not necessarily reflect a significant and/or lasting interest in the enterprise (UNCTAD, 1999).

FPIs are not firm or sector specific and can be used by domestic as well as foreign enterprises. They play an important role in overcoming the credit constraint and improving the liquidity of

  

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domestic capital markets. However, it has often been stated that countries must not rely too much on FPI as they are often very volatile and pro-cyclical.

Even before the Covid-19 pandemic began, India was struggling with falling GDP. One of the measures adopted by the government to encourage investment to promote GDP growth was the removal of superrich surcharge levied on FPIs in August 2019. The objective was to boost investment in the capital market. Initially, the surcharge was announced during the budget in February 2019 but was later revoked as the surcharge resulted in an uncontrolled capital flight from the country. It is important to analyse if such initiatives that provide relaxation for attracting foreign investments actually lead to favourable results or not.

**Table 2: Monthly Net FPI Investments (INR Crores)**

| Month (2019) | Debt | Equity | Hybrid | Total (INR crores) | Month (2020) | Debt | Equity | Debt-VRR | Hybrid | Total (INR crores) |
|---|---|---|---|---|---|---|---|---|---|---|
| January | -4262 | -1301 | 7 | -5556 | January | 12123 | -11648 | 529 | -46 | 957 |
| February | 17220 | -6037 | 871 | 12053 | February | 1820 | 2097 | 2637 | 2416 | 8970 |
| March | 33981 | 12002 | 2769 | 48751 | March | -61973 | -60376 | 4165 | -19 | -118203 |
| April | 21193 | -5099 | 634 | 16728 | April | -6884 | -12552 | 4033 | 544 | -14859 |
| May | 7920 | 1187 | 2264 | 11370 | May | 14569 | -22935 | 1000 | 11 | -7356 |
| June | 2596 | 8319 | 2196 | 13111 | June | 21832 | -1545 | 3766 | 1957 | 26009 |
| July | -12419 | 9433 | -17 | -3003 | July | 7563 | -2476 | -1786 | 1 | 3301 |
| August | -17592 | 11672 | 49 | -5871 | August | 47080 | -3310 | 2762 | 3347 | 49879 |
| September | 7548 | -990 | 25 | 6582 | September | -7783 | 3958 | 406 | 2222 | -1196 |
| October | 12368 | 3670 | 31 | 16069 | October | 19541 | 1641 | 851 | -207 | 21826 |
| November | 25231 | -2358 | 126 | 22999 | November | 60358 | -1806 | 4399 | -169 | 62782 |
| December | 7338 | -4616 | 40 | 2762 | December | 62016 | 4079 | 2463 | 2489 | 71046 |

***Source: National Securities Depository Limited Data***

The relaxation in surcharge was meant to provide huge relief to investors. However, FPI trends during the period reveal that there was a net FPI outflow in August 2019 in spite of this relaxation as can be seen in the Table 2. Further, FPI inflow picked up in September and then followed a positive trend till November then declined by almost 88% again in December 2019. Later in March 2020, there was a massive net capital outflow possibly as the Covid- 19 pandemic started. As can be seen in Table 2, the net FPI inflows have been very volatile. Even if look at FPI trends till December 2019 when the effects of the Covid-19 were almost negligible, net FPI inflows have been unstable. In spite of the waiver, fresh investments could not be brought into the economy. The government not only lost thousands of crores of tax revenue from

  

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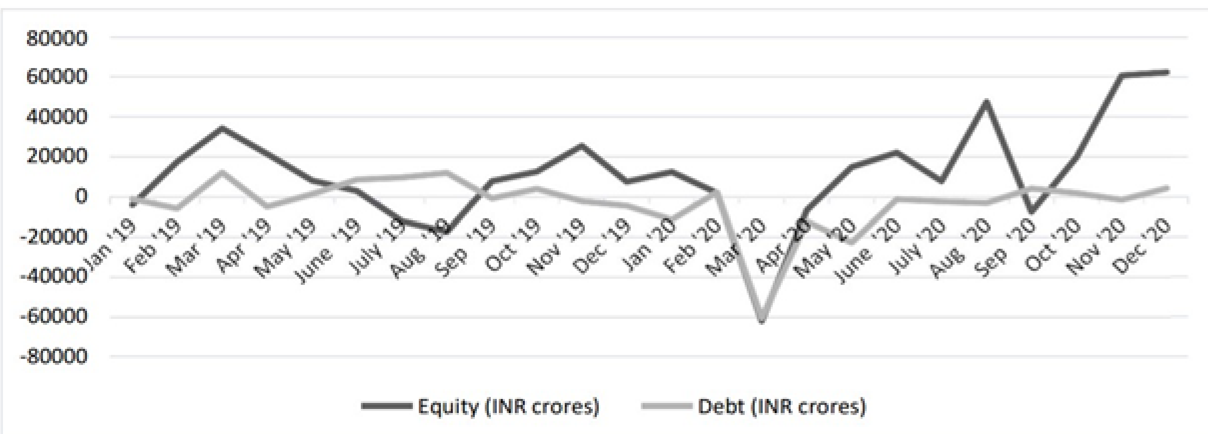
the policy reversal where it removed the surcharge, but it also failed to provide the intended benefits. Such policy reversal could in fact contribute to more uncertainty in markets. They may negatively impact investor sentiments which could perhaps further hurt FPI inflows.

All government initiatives undertaken may hence not be relevant and it may be crucial to rethink the problems at hand. The withdrawal of capital and volatility of inflows indicates that the Indian market is unsafe for foreign investors. It is important to address certain macroeconomic issues such as jobless growth, falling consumer demand, limited fiscal stimulus and a real estate slump. Moreover, such problems have magnified even further as the country struggles during the pandemic.

**Figure 2: Debt and Equity FPI in 2019 and 2020**




***Source: National Securities Depository Limited Data***

The instability of capital streams is portrayed by the high recurrence of reversibility in the capital flows. Figure 2 shows that volatility can be seen in both debt and equity capital from January 2019 to December 2020. The volatility in capital markets may create an unstable domestic environment exerting a negative impact on the economy. Such problems have often led to scepticism related to the importance of FPIs. Too much dependence on foreign portfolio investments must be avoided.

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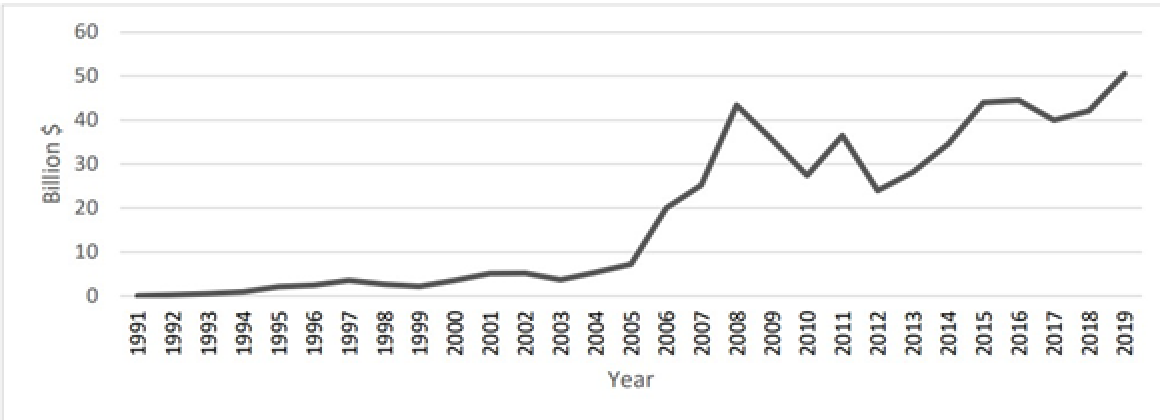
**Figure 3: FDI Net Inflows (Current US$)**




***Source: World Bank Data***

FDI could be preferred over FPI as it is usually comparatively less volatile than FPI. Trends of FDI inflows from 1991-2019 can be seen in Figure 3 given above. FPIs do not create real assets and are hence viewed as less advantageous to FDIs which not only add to the productive capacity but are also longer-term investments. FDI is carried out in recipient countries by establishing production facilities which are difficult to dissolve in a short period of time. FDI is a vital form of non-debt finance in India and is hence seen as a major driver of economic growth. FDI not only primarily brings with it much needed capital, it also serves as a medium of obtaining latest technology and contributes to skill enhancement. Therefore, disinvestment or reversibility is much more difficult to undertake in FDI than in the case of portfolio investment, which can be easily sold off on financial markets.

## V. Concluding Remarks

As the entire world is suffering from a pandemic, global investments have taken a downturn. Businesses are impacted adversely and projected economic recovery is weak. In spite of the waivers provided by the Indian government, the volatility of capital flows highlights the problem of uninsulated markets in the country. There may have been over-reliance focused on obtaining foreign investments only while domestic investors are ignored. Until there is a commitment to resolve structural macroeconomic issues, capital flows could continue to be highly volatile. Further, FDI could be preferred over FPI as they result in creation of real productive assets which create strong linkage effects resulting in long run growth.

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India has managed to obtain record FDI flows but the future is highly uncertain. Even before the pandemic struck the world, the Indian economy was struggling. Future FDI inflows and retention of the existing investment will depend largely on investor sentiments which in turn depend on economic recovery of India. For economic recovery, supply side constrains need to be minimised alongside a revival of consumption demand. The competitiveness of Indian firms also needs to be improved as India faces huge competition from its South-Asian competitors viz. Bangladesh, Vietnam and Thailand.

Moreover, while FDI brings multiple opportunities with it, the associated challenges cannot be overlooked. The Indian government has been too keen on attracting on FDI, but the measures that need to be taken to retain existing FDI may have been side-lined. There is also a tendency to keep coming up with new policies to receive more foreign investments. Contrary to what they are intended for, frequent shifts in policy landscape creates uncertainty. It may in fact be confusing and often irksome for investors and can discourage investments. The policies framed to attract FDI must take a longer- term view and efforts must also be made to retain the existing FDI instead of just being fixated on getting new investments.

There is also a need to obtain FDI inflows into some under-performing Indian states such as Bihar, UP, Rajasthan and MP. These states lag behind in socio-economic indicators and can take advantage of FDI to boost their economy. FDI is largely a non-debt creating capital inflow and can be a catalyst to long run economic growth in these states.

Further, public investments can play a dominant role in improving the domestic manufacturing sector and attracting investments. Public investment and private investments are not substitutes. On the contrary, in terms of attracting and retaining existing FDI, they can be complementary. The prerequisite for initiating an investment boost in the economy is to significantly increase public capital expenditure instead of being over reliant on attracting new foreign investments.

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