

## **Getting Policies Right for Foreign Direct Investment and Exports for a growing India**

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Given that India is one of the four oldest civilizations of the world (along with China, Egypt, Mesopotamia-Babylon), it is not surprising that estimates of India's contribution to world GDP (purchasing power parity in 1990 international dollars) in 1600 was 22.4%, in 1700 was 24.4%, but already by 1820 (after half a century of East India's conquests of Mughal territories) that share had fallen to 16%; after that it fell consistently and in 1950 was 4.2% (Maddison, 1995). By 2019, that share had risen (again in PPP) to 7.09%, but we should also note that India is now also the second most populous country in the world (with 17% of world population).

Hence, a developing country, whose per capita income is only about \$1800 per annum,<sup>1</sup> even though its overall GDP is the sixth largest in the world, should engage with the rest of the world ideally with a strategic vision, driven by the goal of achieving as rapidly as possible its development objectives. A conceptual point here is that for any economy, there are four potential drivers of growth, assuming that growth has to be one paramount development objective. Those four drivers are: private final consumption expenditure; investment, private and public; exports; and public expenditure. This paper will examine only one-and-a-quarter drivers of growth – exports – and also private foreign capital flow contribution to private investment. While most investment in any economy, especially a large economy like India, is accounted for by domestic savings and domestic investment, foreign private investment also plays a significant part.

The brief paper starts with the well-known assumption in development economics that a developing country suffers from two major constraints, given its low initial level of per capita income, on its ability to grow its GDP and achieve higher levels of human development: a savings constraint and a foreign exchange constraint. Therefore, its strategic objectives of development would be met if its engagement with the rest of the world is such that both those constraints can be relaxed. Thus, if its net exports grow rapidly enough, it would drive growth, but also it would ease the ability of the country to increase imports of capital goods to enhance production and productivity at home, because exports would ease the forex constraint.

Secondly, given that most investment (or gross fixed capital formation) in a large economy is driven by domestic savings, the role of foreign savings (including FDI and FPI), while important, can only be secondary. However, Foreign Direct Investment (FDI) can be helpful beyond its specific role in relaxing the domestic savings constraint: it can provide technology, management skills, and access to markets abroad if it can be lured to produce in India not just for the Indian market, but also to export its products or services abroad, thus simultaneously also easing the forex constraint.

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<sup>1</sup> This makes India a Low-middle Income Country (range of \$1046-4095) since 2007, but it still is \$2200 below the threshold for becoming an upper-middle income country and the only G20 country which is LMIC (Indonesia became in 2020 a LMIC from UMIC only because of the Covid impact). UMICs are those with per capita income in 2020 between \$4096 and \$12695.

Another objective of a developing country's engagement with the world is also to support its development objective of structural change, of making a transition from being an agrarian economy, where a high proportion of GDP and employment is accounted for by agriculture to one where non-farm activities predominate, preferably industry and then modern services.<sup>2</sup> This objective acquires greater salience, if the total number of youth in working age is rising at an accelerating pace, as in India.<sup>3</sup> After 2040, India's demographic dividend will be over, and India will become an aging society. Thus, India will become, like much of Europe, North America, Japan an aging society, that must provide for its elderly, who will be out of the productive workforce by then; China too became an aging society after 2015.

India's position in the world will be determined by its economic power, which is a source of the resources needed to become a military power. That is clearly the route that every major power has followed through the last two centuries, not just China in the last four decades.

India's low per capita income, the lowest among the largest 10 economies in the world, and among the BRICS, is a source of its weakness. But its leadership needs to take greater cognizance of the fact that in less than two decades India will become an aging society. Hence, India cannot rest on the laurels of being the second fastest large economy in the world. India's GDP in 2020 was \$2.66 trillion (World Bank, World Development Indicators), which makes it the sixth largest economy in total GDP. To become the third largest economy in the world, India needs to exceed Japan, the third largest currently, and exceed its approximately \$5 trillion economy (2020).

For India to become a \$5 trillion economy, its GDP will need to grow at 7% per annum, for it to reach that goal by 2031 (by which time Japan would also have moved ahead). By contrast, China's GDP in 2020 was \$14.7 trillion, although it started at the same level of per capita income as India in 1979; its human development indicators were then, and still are, much better than India's. In other words, India has no choice but to grow fast; it cannot afford to allow its growth rate to slip below 7%, as it did consistently for three years, post 2016, even before the Covid pandemic hit. Over the two years of Covid, the economy first contracted by -7.3% in FY2020-21 (compared to the world's contraction by 3.1%). India's contraction was the largest in the world among large economies, hence its growth in FY 2021-22 has only just brought it back upto 2019-20 (but in per capita terms it is still below per capita income level in 2019-20).

Aging societies cannot grow their GDP even half as rapidly as developing ones that are in the midst of their demographic dividend. Hence, India's GDP must grow at least at the rate of 7% per annum from 2022 till 2031, otherwise India will not double its current GDP to \$5 trillion (i.e. even seven years after India had claimed it would achieve that goal).

These are the realities that India's policy makers, including those in the Ministry of External Affairs and the Ministry of Commerce and Industry, as well as the captains of the Indian

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<sup>2</sup> This is essential because it is well known that industry and services have a much productivity per person employed in it, than does agriculture. In other words, a fast rate of growth should generate sufficient employment (and output) in the non-farm sectors to absorb growing number of workers each year.

<sup>3</sup> In India five million young people are joining the labour force each year currently; that number will rise at an accelerating pace till 2030, after which their numbers will still keep rising till 2040, but at a decelerating pace.

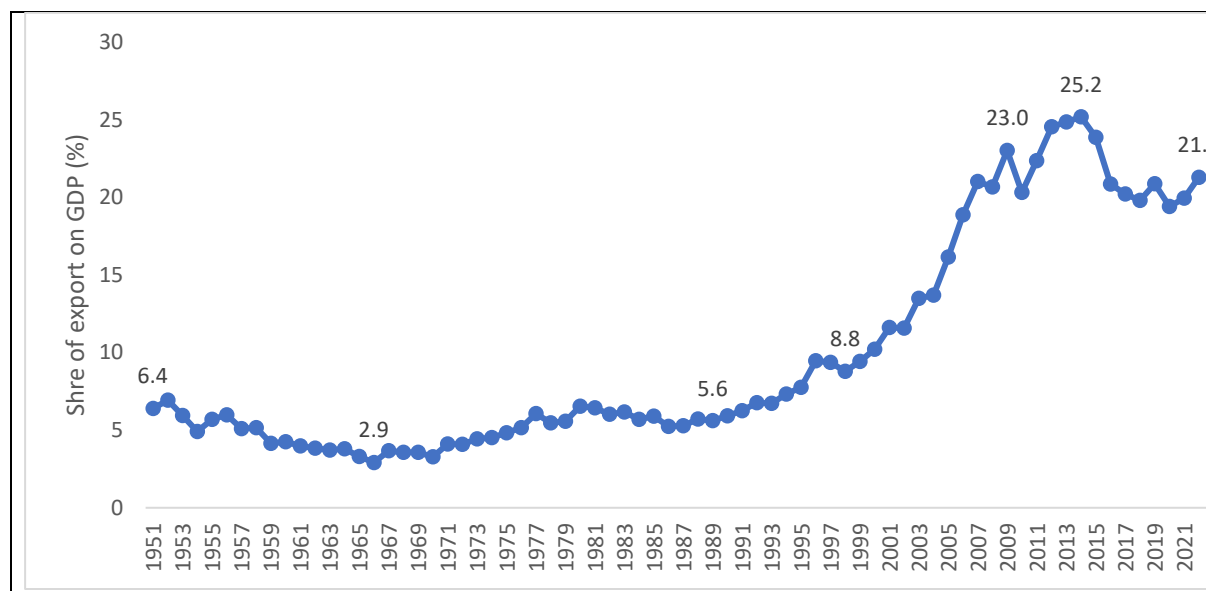
economy, may wish to keep in mind. This is the perspective we bring to bear to our analysis of India's recent economic engagement with the rest of the world.

This short paper is organized with a view to assessing the current conjuncture of India's external economic relations, in respect of export earnings and foreign inward capital flows. We keep in view the preceding theoretical discussion in order to assess the facts. In section 1 we examine the role of exports in relieving India's foreign exchange constraint, and its performance in this regard. Section 2 discusses the role of foreign inflows of productive capital in relieving India's savings constraint, and other constraints that the Indian economy faces. The final section concludes.

## 1. Relieving the foreign exchange constraint: Exports

Exports have a critical role in relieving any country's foreign exchange constraints. Rising exports as a share of GDP is a clear indicator of its ability to relieve that constraint (see Figure 1).

Figure 1: Share of Exports on GDP in India, 1951-2021



Source: Ministry of Finance, Economic Survey 2022

India was an inwardly-looking, relatively closed economy, for forty years from 1951 and 1991, with the share of exports in GDP below 6.5% for the entire period. That changed dramatically, with a new emphasis on exports from 1991 and an outwardly looking strategy of development, implicit in the Industrial Policy Statement of the government of India in 1991. (Encouraging foreign direct investment, FDI, was also an element of that strategy, apart from domestic deregulation and de-licencing of industrial capacity.)

The results of that strategy are visible for exports in Figure 1. Over 1991-2014 the compound annual growth rate of India's export is 15.67 percent during 1990-91 to 2013-14 while GDP registered 6.84 percent growth per annum during the same period (RBI, 2014; Burangi and Ketkar, 2018). Similarly, Virmani (1991) analyzed the demand and supply side factors which affected the exports and imports of India were analyzed over 1961-62 to 1985-86. The total

merchandise export was divided into manufactured exports and primary exports. He found that India's export of manufactured goods was price elastic. The 10 percent depreciation in the domestic currency led to 15 to 19 percent increase in the value of India's export of manufactured goods. However, as far as primary products are concerned, the value of their exports was not changed significantly due to depreciation of currency – an important conclusion that we discuss further later in this section.<sup>4</sup> In addition to this, world demand had positive impact on both primary and manufactured exports.

Ghatak and Price (1997) examined the causal relation between exports and its determinants for the period 1960-1992. They established that non-traditional manufactured export granger-cause output growth, again a finding very relevant for further discussion. On the other hand, the causal relationship between traditional exports and output was not significant. The study highlighted the fact that the segregation of exports gave the clear idea about the export-led hypothesis. Total export did not cause an increase in output because of the dominance of the traditional export.<sup>5</sup> In spite of having strong industrial base, India's export was dominated by resource-based products. The contribution of high technology products was found to be lower than that of the other south Asian countries like China, Taiwan, Korea, Malaysia, Singapore and Indonesia. They concluded that India needs to attract export oriented FDI for promoting the export of high-technological intensive products – a finding of relevance to the theme of this paper.

Burangi and Ketkari (2018) show the dominance of export resource-intensive manufactures and non-fuel primary products during 1990-91, which indicated that country was suffering from a lack of a diversified export and industrial base. With economic reforms, a planned policy framework for heavy industrial base, and increase in the infrastructural facilities, etc., led to export growth. Furthermore, rising share of high-l and medium-skill technology intensive manufacturing shows that manufacturing base for high value added manufactured exports was improving. The declining share of resource-intensive and primary fuel products showed the economy moving was up the quality ladder. The export basket changed due to the contribution of new products and disappearance of some other products from the export basket.

Furthermore, determinants of exports show that there exists bi-directional causality between economic growth and exports. Rise in export also has favorable impact on FDI. It also suggests that the export promotional policies of the government were also helping in increasing investment.

However, *since 2014-15 India's merchandise exports fell in dollar terms consistently for five years in a row*, and remained below their 2013-14 level. This was an unprecedented, new development and occurred for the first time since 1991. As a result the share of exports in

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<sup>4</sup> Sharma (2003) examined the determinants of India's export performance for the period 1970 to 1998. Using two-stage least squares method, he stated that export demand was adversely affected by rupee appreciation. Ten percent appreciation of rupee led to reduction of the export demand by 3.39 percent.

<sup>5</sup> Similarly, Konya and Singh (2009) analyzed the causal relationship between Indian exports, imports and GDP for the period 1950-51 to 2003-04. The study highlighted the importance of segregated GDP. The causality results showcased long-run relationship between GDP and exports. Two-way causality was observed between manufacturing GDP and export. However, in case of agricultural GDP, uni-directional causality was found from export to agricultural GDP.

GDP, which had consistently risen, fell (see Figure 1). The exports of services was able to sustain growth of total exports (in \$ terms) from India, but could not prevent the contribution of exports to India's growth from falling sharply, well before the Covid collapse in global demand. In fact, the fall post 2015 is to levels below the one year dip in the year following the global economic crisis of 2008-09.

The underlying causes of merchandise exports falling has to be understood. One reason affected all countries: the share of world trade in world GDP was 37% in 1987, after which it consistently rose all the way till 2008, peaking at 61% of world GDP. This share, after the collapse due to the global economic crisis, recovered to 60% in 2011. Despite this fluctuation, India's exports to GDP rose in US dollar terms as well as a share of GDP till 2011. After 2011 the share of global trade in World GDP fell marginally each year after that, and was 58.5% in 2014. Nevertheless, the share of India's exports to GDP rose consistently till 2014 (see Figure 1).

Since then the share of trade in world GDP fluctuated between 56 and 58% of world GDP till 2019. But India's merchandise exports to GDP collapsed in dollar terms, as well as a share of India's GDP (see Figure 1), although that did not happen with other Asian countries like China, Vietnam or Bangladesh. There are domestic causes of this Indian collapse in merchandise exports, which account for two-thirds of total exports (the remainder being services).

But in order to understand the recent collapse one also has to examine this fall in the light of what was an important cause of rising exports from 1994-5 all the way to 2014-15, i.e. for full two decades. One important reason is the trend in the real effective exchange rate of the rupee (REER).<sup>6</sup> The REER, based on a 36-currency index, was maintained at the same level throughout the period 1994-2014. It was not allowed to appreciate. The appreciation of the rupee against other currencies would have made imports cheaper for Indians, and exports more expensive for foreigners who wanted to buy our products or services.<sup>7</sup>

However, the opposite was allowed to happen since 2014. The real effective exchange rate of the rupee appreciated after 2013-14, making India's exports more expensive, which in turn made India less competitive relative to other countries, who were India's competitors in the same products. With base year 2004-5 as 100, the REER was still 103.27 in 2013-14. It rose to 109 in 2014-15, 112 in 2015-16, 114.5 in 2016-17, 119.7 in 2017-18, 114 in 2018-19, and was 116.75 in 2019-20. In other words, foreign exchange management was such that the REER was allowed to appreciate. This adversely affected all exports uniformly.

Imports, which were 28.4% of GDP in 2013, fell to 26% in 2014, to 22.1% in 2015, then to 20.9% in 2016, then recovered a bit to 23.7% in 2018, but fell again sharply to 21% in

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<sup>6</sup> The real effective exchange rate (REER) is **the weighted average of a country's currency in relation to an index or basket of other major currencies**. The weights are determined by comparing the relative trade balance of a country's currency against that of each country in the index. The nominal effective exchange rate is measured with the nominal parts (therefore without taking account of the differences in purchasing power between the two currencies), while the real effective exchange rate includes price indices and their trends.

<sup>7</sup> Table 6.5 in Ministry of Finance (2020-01) presents the trade-weighted REER for each year from 1994-5 to December 2020.

2019, and 18.4% in 2020. Falling imports reflects a falling aggregate demand within India, which was reflected in the consistently falling GDP growth rate. Of course an important reason for falling imports was that crude oil prices fell sharply from their April 2014 peak of \$118.3 per barrel to a level between \$60-80 after August 2015, down to between \$40-60 between June 2018 to November 2020, before climbing back up (crude is one-fourth of India's imports). Thus for most of the five years that export earnings were falling, there was comfortable cushion for India in that crude oil prices gave the government a windfall gain in terms of reduced domestic fiscal subsidy burden (since domestic crude prices became dependent upon market forces).

A cushion to India's foreign exchange earnings was also provided over the last two decades by the surge in service exports (Chinoy 2018). In 2003, service exports constituted 30 percent of the total export basket. But in a matter of just four years, service exports rose to 40 percent of the total basket, reflecting the software and BPO revolution around the world in which India was a major participant. But then service exports plateaued at 40 percent of the total basket over the last decade.

During this time, there has also been a quiet revolution occurring on the manufacturing side. In 2003, textiles, leather, and gems/jewelry, India's traditional exports, constituted nearly 60 percent of the merchandise export basket (ex-petroleum). But their share fell secularly, and currently they account for just 40 percent of the basket. In contrast, engineering goods exports, mainly auto parts and capital goods, grew at an average annual pace of almost 20 percent for 13 years, such that their share of exports in the manufacturing export basket leapt from 20 to 35 percent in just 12 years to 2018. As we noted earlier, therefore, India's exports have become much more "high-tech" over the last two decades and also improved in technological content, quality, sophistication, and complexity. By 2015, engineering goods, electronics, and pharmaceuticals/chemical products constituted almost 60 percent of the non-oil merchandise basket. These are capital-intensive sectors, when India needs job creation in labor-intensive sectors, whose share has reduced in the export basket.

The surge of export had other implications. The surge in private investment witnessed at the time (with gross fixed capital formation growing at 16.2 percent the five years 2004-2008) was largely responding to the buoyancy of external demand rather than domestic demand. Exports were driving investment, and this is also seen in the close correlation between exports and investment (another driver of GDP growth) during those years, almost in East Asian fashion (Chinoy, 2018).

So in summary, global growth and REER dynamics were able to explain a significant deceleration of export growth in the period 2015-19. However, other factors (e.g., demonetization/ GST) were temporarily responsible for depressing export growth below what global growth and exchange rate dynamics would have suggested.

## 2. India as a destination for foreign direct investment and foreign portfolio investment

We now turn to an analysis of FDI and foreign portfolio investment (FPI), and its contribution to filling the gap left by the difference between exports and imports, and their other roles (relieving the savings constraint, foreign exchange, and contributing to technology, management skills, links to global markets).

Table 1 presents the dollar values of each type of capital flow; Table 2 shows the same information as a share of GDP to assess what contribution FDI and FPI made to the overall investment process in India.

**Table 1: FDI and FPI to India, 2000-2020**

Year	Foreign Direct Investment		Foreign Portfolio Investment		Total	Total
	Rs Crore	\$ million	Rs crore	\$ million	Rs crore	\$ million
1						
2000-01	14924	3272	11820	2590	26744	5862
2001-02	22630	4734	9290	1952	31920	6686
2002-03	15594	3217	4504	944	20098	4161
2003-04	10944	2388	51898	11356	62842	13744
2004-05	16745	3713	41312	9287	58057	13000
2005-06	13425	3034	55357	12494	68782	15528
2006-07	34910	7693	31881	7060	66791	14753
2007-08	63776	15893	110619	27433	174395	43326
2008-09	100106	22372	-65045	-14030	35061	8342
2009-10	85983	17966	153967	32396	239951	50362
2010-11	54101	11834	139381	30293	193482	42127
2011-12	103167	22061	85571	17170	188738	39231
2012-13	108186	19819	146467	26891	254653	46711
2013-14	129969	21564	29680	4822	159650	26386
2014-15	191219	31251	257853	42205	449072	73456
2015-16	235782	36021	-27203	-4130	208579	31891
2016-17	238913	35612	50482	7612	289394	43224
2017-18	195052	30286	142632	22115	337684	52401
2018-19	214036	30712	-1857	-618	212179	30094
2019-20	304820	43013	7395	1403	312215	44417

Source: RBI

Both FDI and FPI are sources of foreign exchange, hence both have a role in relieving a developing country's forex constraint, and savings constraint. However, we should also keep in mind that FPI, by its very nature, is fickle and is much more volatile and cannot be seen as a stable source of foreign exchange in a developing economy. Also, it does not, unlike FDI, create stable long term investment, with all its spillover effects.

We first examine FDI, which can be of two kinds: for new greenfield projects or for the purposes of acquiring (through Mergers and Acquisition, M&A) Indian firms in brownfield locations. Clearly, the first should be preferred (compared to FDI in the form of M&A) – as it generates new capital investment (as opposed to acquiring existing assets). India was a relatively closed economy till the economic reforms post-1991, and had experienced very limited FDI, and we can see that FDI is growing since 2000.

FDI inflows were stable from 2000 to 2005-6, but then doubled in 2006-7 to \$7.7 billion (compared to the previous year), and doubled again in 2007-8 to \$15.6 billion. After the global economic crisis (2008-09) it fell for two years, but then rose sharply again to \$19 to \$21 billion between 2011-2 and 2013-14.<sup>8</sup>

Analytically it is more important to examine Table 2, that shows the share of FDI (and FPI) in India's GDP. The ratio enables us to address the question: how important was FDI to India's investment rate overall? This is of paramount importance because it is investment that is the main driving force behind sustained GDP growth. The main reason for the unprecedented GDP growth of 8% pa between 2003-4 and 2014-15 was the sharp upswing in domestic savings and investment rates. Savings and investment as a share of GDP rose from 23% and 24% in 2002-3 to 37% and 38% in 2007-8, especially in the field of infrastructure. However, FDI, even at its peak in 2008-9 in the last two decades, was merely 1.82% of GDP – or a minuscule fraction of total investment, private and public in India.

Table 1 shows that the absolute value of FDI rose after 2013-14, and has remained between \$30.2 billion to \$43 billion. Table 2 also shows that the share of FDI in GDP rose and was between 1.13% at its lowest to 1.71% at its highest. However, overall investment to GDP itself fell significantly after 2013-14. In the three years 2011-12 to 2013-14 the average of investment to GDP ratio was 33%. Between 2014-15 and 2016-17 the investment to GDP ratio fell to 29% on average, and then fell even further.<sup>9</sup> Provisional figures for FDI in 2020-21 indicate that \$52 billion flowed into India, which is the highest for any year since 2000. Nevertheless, the downward slide in overall investment to GDP has not stemmed.

The larger point is that in a large economy, the contribution of FDI to investment is likely to be limited. FDI inflows during 1990-2017 represented an average share of almost 9 per cent of gross fixed capital formation (GFCF) in developing countries, compared to 8 per cent in developed countries (Roy et al, 2019). However, in India the share of FDI in GFCF or investment in GDP has never exceeded 3%, not once in the last two decades.

Finally, foreign portfolio trends have become very volatile in recent years, which is what one expects, even negative in several years (see Table 2). These flows are not reliable

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<sup>8</sup> It is interesting that foreign portfolio inflows into India's capital markets also followed a similar pattern of growth – of initial rise till 2007-8, then a collapse (with outflows due to the global economic crisis), followed by a sharp recovery.

<sup>9</sup> It fell further to 28% over 2017-18 to 2019-20 – all of which is reflected in the consistently falling GDP growth rate, before Covid. The provisional estimates that are available for 2020-21 and 2021-22 shows further falls to 25.5% over the Covid years.



sources of foreign exchange. We will return shortly to the impact of downsides of large capital inflows, and its consequences for exports.

**Table 2: FDI and FPI as a share of GDP, 2000-2020**

Year	FDI share in GDP	FPI share in GDP	Total FDI & FPI share in GDP
2000-01	0.70	0.55	1.25
2001-02	0.98	0.40	1.38
2002-03	0.63	0.18	0.81
2003-04	0.39	1.86	2.25
2004-05	0.53	1.30	1.82
2005-06	0.37	1.52	1.89
2006-07	0.82	0.75	1.57
2007-08	1.30	2.26	3.56
2008-09	1.82	-1.18	0.64
2009-10	1.35	2.42	3.77
2010-11	0.71	1.83	2.53
2011-12	1.18	0.98	2.16
2012-13	1.09	1.47	2.56
2013-14	1.16	0.26	1.42
2014-15	1.53	2.07	3.60
2015-16	1.71	-0.20	1.51
2016-17	1.55	0.33	1.88
2017-18	1.14	0.83	1.98
2018-19	1.13	-0.01	1.12
2019-20	1.50	0.04	1.53

Source: Estimated from Ministry of Finance, Economic Survey, 2021.

### *Qualitative issues of FDI to India*

Between 1991-2 and 2000-1 the level of FDI was normally below \$3 billion in a year; it began to rise only in the current century (Table 1). In the first five years of the current century FDI just barely exceeded \$3 billion. Since 2005 FDI increased. However, moving beyond this issue of volume of FDI, we now turn to more qualitative issues, like sectoral distribution of FDI and the objectives behind this FDI.

In Table 3 we present the data for FDI to India by source-country. When two countries that are city states practically – first Mauritius, then from 2005 Singapore – account for over 50% of total FDI to a large economy like India, the obvious question as to why this is the case needs to be answered.

Thanks to its low 3% capital gains tax, quality regulatory framework, professional labor, geographical proximity, cultural affinities, and historical ties with India, Mauritius is the most attractive conduit for investments into India. However, more recently Singapore has become a much bigger source.

Singapore also has an extensive double tax treaty network with most countries worldwide, which combined with the absence of capital gains and dividends tax, makes it a very attractive jurisdiction for business investments through a Singapore-incorporated holding company. Mauritius led as a source between 2000 and 2009, but picture rapidly changed thereafter. Mauritius' investments into India grew by 271 percent between 2005-06 and 2008-09; investments from Singapore catapulted 1,077 percent over the same period.

This was a combination of two processes. The first theme was a desire of the Indian government to move away from the Mauritius type of treaty because of the absence of any clauses that would allow for the 'limitation of benefits' (LOB) on account of which Mauritius began being used to "round-trip" money — a misuse of the double taxation avoidance treaty to avoid paying taxes by routing investments through Mauritius. Lawyers call this 'frau legis' or the abuse of law concept. The second initiative was India signing the Comprehensive Economic Cooperation Treaty with Singapore. It appears that one of the compulsions before the government was to work out a treaty with a country that had excellent legal systems so tax benefits would not be misused as in the case of Mauritius.

A major portion of the business of FDI subsidiaries mainly concentrated in the domestic market. The share of export of FDI subsidiaries in total sales accounted for 31.8 per cent on an average during 2012-2019, while the remaining sales are for the domestic market (Roy et al, 2019). 'Information and communication services' remained the major export-oriented sector during 2018-19. The foreign subsidiaries largely depend on Indian domestic market for procurement of raw materials, parts etc.. Domestic purchases are about 62% and imports are 38% of total input procurement.

#### *Flows of FDI by end-use industry*

<b>TABLE 3: FOREIGN DIRECT INVESTMENT FLOWS TO INDIA: COUNTRY-WISE AND INDUSTRY-WISE (US\$ million)</b>					
<b>Source/Industry</b>	<b>2015-16</b>	<b>2016-17</b>	<b>2017-18</b>	<b>2018-19</b>	<b>2019-20 P</b>
<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>	<b>5</b>	<b>6</b>
Total FDI	36,068	36,317	37,366	38,744	42,629
<b>Country-wise Inflows</b>					
Singapore	12,479	6,529	9,273	14,632	12,612
Mauritius	7,452	13,383	13,415	6,570	7,498
Netherlands	2,330	3,234	2,677	2,519	5,295
Cayman Islands	440	49	1,140	863	3,496
U.S.A.	4,124	2,138	1,973	2,823	3,401
Japan	1,818	4,237	1,313	2,745	2,308
France	392	487	403	375	1,167
United Kingdom	842	1,301	716	1,211	1,125
South Korea	241	466	293	982	777
Hongkong	344	134	1,044	598	678

Cyprus	488	282	290	161	657
Germany	927	845	1,095	817	443
Belgium	57	172	213	56	388
U.A.E.	961	645	408	853	323
Luxembourg	784	99	243	251	252
UK Virgin Islands	203	212	21	290	250
China	461	198	350	229	162
Others	1,725	1,905	2,498	2,768	1,796
<b>Sector-wise Inflows</b>					
Manufacturing	8,439 (23.3)	11,972 (32.3)	7,066 (18.8)	7,919 (20.4)	8,153 (19)
Communication Services	2,638	5,876	8,809	5,365	6,838
Retail & Wholesale Trade	3,998	2,771	4,478	4,311	4,914
Financial Services	3,547	3,732	4,070	6,372	4,326
Computer Services	4,319	1,937	3,173	3,453	4,104
Business services	3,031	2,684	3,005	2,597	3,684
Restaurants and Hotels	889	430	452	749	2,546
Transport	1,363	891	1,267	1,019	2,333
Construction	4,141 (11.3)	1,564 (4.1)	1,281 (3.2)	2,009 (5.2)	1,937 (4.5)
Electricity and other energy Generation, Distribution & Transmission	1,364	1,722	1,870	2,427	1,906
Real Estate Activities	112	105	405	213	564
Education, Research & Development	394	205	347	736	528
Miscellaneous Services	1,022	1,816	835	1,226	443
Mining	596	141	82	247	217
Trading	0	0	0	0	0
Others	215	470	226	102	137
P: Provisional.					
Note: Includes FDI through SIA/FIPB and RBI routes only. Figures in brackets show share of total FDI in that year to that sector.					
Source: RBI.					

The sectoral distribution of FDI is of enormous importance for a developing country which is attempting a structural change in its economy from agriculture to industry and services. The share of manufacturing in total FDI inflow reduced from 61.13 percent during 1991-1999 to 30.21 percent during 2000-2010. While in the same period the share of services sector in FDI increased from mere 15.25 percent to 63.9 percent (Sutradhar, 2014). This increase in services share may be due to changes in FDI policies and also due to the change in the composition of world's inward FDI. Before the economic reforms began, between 1960 and 1990 the share of manufacturing in FDI had risen from 30% to 83% (and had been in the 80% range through the 1980s), while the share of services fell from 20 to 5% over the same period.<sup>10</sup>

<sup>10</sup> Between 1960 and 1990, the remaining contribution was of the Plantation and Petroleum sectors.

Services began absorbing most of the FDI after 2000. What stands out is that Services (communication services, trade, financial services, computer services, business services, restaurant and hotels, transport, real estate activities, education and miscellaneous services) account for around 70% of total FDI (see Table 3) . Meanwhile, the share of Manufacturing has hovered below 24% (with the exception of 2016-17). This is an issue of some concern, given that ‘Make in India’ (since 2014) was targeting greater FDI in manufacturing in India; it is also of concern since the share of manufacturing in GDP fell from its sustained level over 1991-2015 to 15% and then 13%.

After the liberalization of the Indian economy, the inflow of FDI in the country started increasing in the service sector. As a result the export of business services also started increasing at a rapid rate. Business service includes Information Technology (IT), and Information Technology Enabled Services (ITeS). The IT-ITeS industry has four major sub-components: IT services, business process outsourcing (BPO), engineering services and research and development (R&D), and software products. NASSCOM estimates India’s IT and BPO sector (excluding hardware) revenue was US\$ 87.6 billion in 2011-12, generating direct employment for nearly 2.8 million persons and indirect employment of around 8.9 million. As a proportion of national GDP, IT and ITeS sector revenues have grown from 1.2 per cent in 1997-8 to an estimated 7.5 per cent in 2011-12. (Reserve Bank, 2012). The growth rate of software services is always higher than growth rate of services (except for the year 2004-05). In other word software growth in the economy had propelled the service export in India since 2000-01 (Sutradhar, 2014).

#### *The role of Mergers and Acquisitions (M&A) in FDI in recent years*

We had noted at the beginning that an important issue for a developing economy is whether FDI is flowing in for new projects and greenfield sites, or to acquire existing enterprises. Naturally, the former is to be preferred because the new projects add to productive or service generation capacity, creating new jobs, rather than replacing existing owners and management with new management.

UNCTAD (2021) reports that FDI in South Asia rose by 20 per cent to \$71 billion in 2020, driven mainly by strong M&As in India. Amid India’s struggle to contain the COVID-19 outbreak, robust investment through acquisitions in ICT (software and hardware) and construction bolstered FDI. Cross-border M&As surged 83 per cent to \$27 billion, with major deals involving ICT, health, infrastructure and energy. Large transactions included the acquisition of Jio Platforms by Jaadhu (a subsidiary of Facebook (United States)) for \$5.7 billion, the acquisition of Tower Infrastructure Trust by Brookfield (Canada) and GIC (Singapore) joint venture (with Phoenix Mills) of real estate for \$3.7 billion and the sale of the electrical and automation division of Larsen & Toubro India for \$2.1 billion. Another megadeal – Unilever India’s merger with GlaxoSmithKline Consumer Healthcare India (a subsidiary of GSK United Kingdom) for \$4.6 billion – also contributed.

UNCTAD (2017) had similarly noted that M&A had become an important reason for increased FDI to India in 2016. The Acquisition of Essar Oil by the Russian firm Rosneft was the biggest merger that year for \$13 billion. In fact, UNCTAD noted that multinational enterprises see M&A as a means to increase their ‘penetration of the large Indian market’.

#### *Rising capital inflows as a factor in appreciating real effective exchange rate*

We noted in section 1 that there was a sharp drop in merchandise exports after 2014, and the role of appreciating REER in that drop. However, we now wish to examine why such an appreciation in the REER has been happening. We had noted that the REER had not appreciated at all during 2000 to 2014.

In this context, Chinoy (2018) rightly notes: “Foreign direct investment (FDI) levels have increased in the recent years and are a major source of financing for the economy’s current account deficit (CAD). Similarly, foreign portfolio participation into the equity and debt markets has progressively increased and has provided much-needed liquidity and a more diversified investor base. More generally, asset prices in India are increasingly correlated with global asset prices—the ultimate manifestation of India’s progressive financial integration.”

Nevertheless, we must note, that there is a clear link between the rise in FDI and FPI and the appreciation of the rupee (on account of the increased supply of foreign exchange into India). The latter was responsible, among other factors, for the fall in exports of goods (as we had discussed in section 1). So the increase of foreign capital inflows has not been a unalloyed benefit to the Indian economy.

#### **Final remarks**

India’s economy had slowed sharply after 2016, despite a large windfall gain India experienced on account of falling oil prices. A significant share of that windfall gain was spent in increased spending on welfare goods. That spending did not help to expand falling investment (as exports had slowed). The result was continuing slowing of GDP growth, and yet further falls in investment, all the way to 2019. Thereafter, the Covid pandemic has caused the economy to contract. There is a significant risk that rising crude oil prices even before the Ukraine war will hurt the post-pandemic recovery, and reinforce already high inflation, causing a further economic recession.

The policy implication is that India will need to look for new growth drivers, not just higher exports, as de-globalization had already set in across the world. Increased capital outflows from India is likely as the US Fed raises interest rates, and India’s debt market becomes less attractive to foreign portfolio investors. India’s policy makers will need to think beyond trying to securing FDI as a means of raising growth or exports, especially given the composition of FDI that we have noted. India needs an explicit Industrial Policy and a manufacturing strategy (Mehrotra, 2020), which it has not had since 1991, in which FDI and export growth need to be integrated as a means of hastening India’s growth process.

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