

NEWSLETTER

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Analysis

FDI and Indian growth: the new paradigm

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The Foreign Direct Investment (FDI) environment in India has undergone a sea change since the inception of economic reforms in 1991. The positive changes can be particularly attributed to the evolving policy framework. The government now acts as a 'facilitator' of private investment by creating an enabling environment. It bridges the gaps in critical infrastructure to encourage investment and acts as a 'partner' to the private sector in 'public-private partnerships' (PPP). There has been a widely accepted view that FDI flows to India would accelerate over time given the positive medium to longer-term prospects for the economy. The performance so far has been encouraging.

According to the A.T. Kearney 2007 Report on the FDI Confidence Index, India continues to rank as the second most attractive FDI destination, with China as number one and the United States as number three. India displaced the United States in 2005 to gain number two position which it has held ever since. FDI inflows in 2006 reached US\$19.6 billion. In 2007, total FDI inflows in India stood at US\$23 billion showing a growth rate of 43.2 per cent over 2006. This is a positive sign and even the ratio of India's FDI Inflows to China's inflows has been consistently increasing since 2000 with Indian FDI rising from a few

per cent of China's FDI inflow to 25 per cent in 2007.

In the context of the present global economic crisis, financial flows in the form of FDI to developing economies might be expected to slow down. But according to the latest press release by UNCTAD in February 2009, FDI inflows to developing countries have remained positive for 2008 at an estimated 4 per cent (FDI inflows to developing economies increased from US\$499 billion in 2007 to an estimated US\$518 billion in 2008). Falls in FDI inflows to the developing world are expected to be more widespread in 2009 as the worst impact of the crisis is expected to hit these countries only by the end of this year. All host countries will be making extra efforts to attract the reduced quantum of international capital that is available. India is expected to continue to fare better due to huge domestic demand and investor-friendly policies with the government having set a revised FDI target of US\$30 billion FDI for 2008-09.

Investment Outlook

The initial numbers on FDI flows for the year have been surprisingly positive. Though 'hot money' (portfolio funds) withdrew sharply during 2008-09, FDI remained strong throughout the year. Sustaining the recent momentum itself has been a significant pointer to the investment needs of the economy. In spite of the global meltdown, in 2008 total FDI inflows into India stood at US\$33.4 billion. The country posted a 45 per cent growth in FDI with US\$23.3 billion

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between April and December 2008. The investment flows came in lumps. The FDI inflow for February 2009 alone was US\$1.5 billion, which was lower than the January achievement of US\$2.7 billion – a sharp drop of 73 per cent. Even though the overall flow has been satisfactory, it is still necessary to maintain a positive environment for all investment so that investments overall, and not just FDI, pick up.

Government Initiatives

The government has taken several measures to encourage the injection of FDI in India. There is a paradigm shift evident in the new Foreign Direct Investment press release issued by the Department of Industrial Policy and Promotion on 17 February 2009. The government modified the guidelines for calculation of foreign investment and the transfer of ownership or control of Indian companies to non-resident entities. This is an attempt to create investor-friendly, credible and predictable regulations that facilitate greater foreign capital inflows and send a positive signal in the present difficult economic circumstances.

The amendment in the regulation focuses on the more sensitive sectors, such as retail, telecommunications, banking, media, aviation, defense and insurance, which previously had high barriers for foreign investment. The FDI cap for the Indian telecommunications sector, for instance, is no longer 74 per cent but a whopping 98 per cent. FDI up to 100 per cent is allowed automatically in all activities and sectors except for a few such as gambling and betting, lotteries, atomic energy, multi-brand retail, real estate trading, and agriculture. No environmental clearances are required for projects with an investment of less than Rs. 1 billion.

Amendments in the policy also introduce a new concept of controls and ownership

in the sector. An Indian company that is backed by foreign investments but ultimately controlled and owned by Indians can invest without being subject to the FDI cap. However, the government has not yet offered any details on the new FDI caps in sectors like media and banking.

Apart from these measures, reasonable performance of the corporate sector in India and a positive economic growth rate of 6-7 per cent in GDP despite the global economic crisis, are positive signals to foreign investors of the resilience of the Indian economy.

For foreign investors who have survived the crisis at home and are still looking to invest, India is one of the few attractive options after China because of its huge domestic market driven largely by domestic demand making their investment stable and profitable.

Even though India is unlikely to achieve even the truncated FDI target of US\$ 30 billion in 2008-09, it has already seen an expansion of the inflow of FDI in the middle of a difficult global environment. With the government planning further FDI liberalization measures across a range of sectors (such as the insurance, media and aviation sectors) and continued investor interest, FDI into India is expected to continue to accelerate.

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