# FDI

## Introduction

Foreign direct investment (FDI) is an investment from a party in one country into a business or corporation in another country with the intention of establishing a lasting interest. Lasting interest differentiates FDI from foreign portfolio investments, where investors passively hold securities from a foreign country. A foreign direct investment can be made by obtaining a lasting interest or by expanding one's business into a foreign country.

## How a Foreign Direct Investment Works

Foreign direct investments are commonly made in open economies that offer a skilled workforce and above-average growth prospects for the investor, as opposed to tightly regulated economies. Foreign direct investment frequently involves more than just a capital investment. It may include provisions of management or technology as well. The key feature of foreign direct investment is that it establishes either effective control of or at least substantial influence over the decision-making of a foreign business.

The Bureau of Economic Analysis (BEA), which tracks expenditures by foreign direct investors into U.S. businesses, reported total FDI into U.S. businesses of $253.6 billion in 2018. Chemicals represented the top industry, with $109 billion in FDI for 2018.

## Special Considerations

Foreign direct investments can be made in a variety of ways, including the opening of a subsidiary or associate company in a foreign country, acquiring a controlling interest in an existing foreign company, or by means of a merger or joint venture with a foreign company.

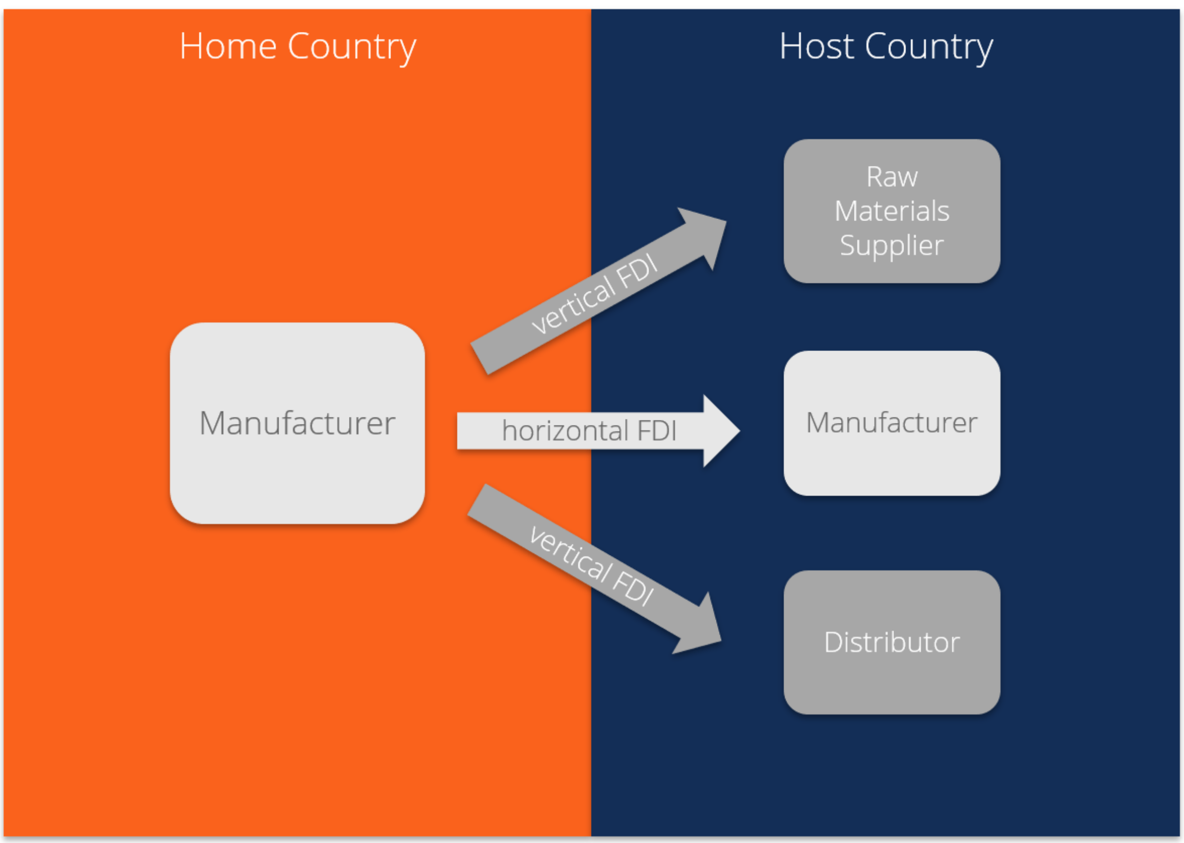
The threshold for a foreign direct investment that establishes a controlling interest, per guidelines established by the Organization of Economic Co-operation and Development (OECD), is a minimum 10% ownership stake in a foreign-based company. However, that definition is flexible, as there are instances where effective controlling interest in a firm can be established with less than 10% of the company's voting shares.

**Types and Examples of Foreign Direct Investment**

Typically, there are two main types of FDI: horizontal and vertical FDI.

**1. Horizontal:** a business expands its domestic operations to a foreign country. In this case, the business conducts the same activities but in a foreign country. For example, McDonald's opening restaurants in Japan would be considered horizontal FDI.

**2. Vertical:** a business expands into a foreign country by moving to a different level of the supply chain. In other words, a firm conducts different activities abroad but these activities are still related to the main business. Using the same example, McDonald's could purchase a large-scale farm in Canada to produce meat for their restaurants.




However, two other forms of FDI have also been observed: conglomerate and platform FDI.

**3. Conglomerate:** a business acquires an unrelated business in a foreign country. This is uncommon, as it requires overcoming two barriers to entry: entering a foreign country and entering a new industry or market. An example of this would be if Virgin Group, which is based in the United Kingdom, acquired a clothing line in France.

**4. Platform:** a business expands into a foreign country but the output from the foreign operations is exported to a third country. This is also referred to as export-platform FDI. Platform FDI commonly happens in low-cost locations inside free-trade areas. For example, if Ford purchased manufacturing plants in Ireland with the primary purpose of exporting cars to other countries in the EU.


**Methods of foreign direct investment**

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

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

## National FDI Policy Framework

Foreign direct investment (FDI) in India is a major monetary source for economic development in India. Foreign companies invest directly in fast growing private Indian businesses to take benefits of cheaper wages and changing business environment of India. Economic liberalization started in India in wake of the 1991 economic crisis and since then FDI has steadily increased in India, which subsequently generated more than one crore (10 million) jobs. According to the

Financial Times, in 2015 India overtook China and the United States as the top destination for the Foreign Direct Investment. In first half of the 2015, India attracted investment of $31 billion compared to $28 billion and $27 billion of China and the US respectively.

On 17 April 2020, India changed its foreign direct investment (FDI) policy to protect Indian companies from "opportunistic takeovers/acquisitions of Indian companies due to the current COVID-19 pandemic", according to the Department for Promotion of Industry and Internal Trade. While the new FDI policy does not restrict markets, the policy ensures that all FDI will now be under scrutiny of the Ministry of Commerce and Industry.

**Advantages of Foreign Direct Investment**

**1. Increased Employment and Economic Growth**

Creation of jobs is the most obvious advantage of FDI. It is also one of the most important reasons why a nation, especially a developing one, looks to attract FDI. Increased FDI boosts the manufacturing as well as the services sector. This in turn creates jobs, and helps reduce unemployment among the educated youth - as well as skilled and unskilled labor - in the country. Increased employment translates to increased incomes, and equips the population with enhanced buying power. This boosts the economy of the country.

**2. Human Resource Development**

This is one of the less obvious advantages of FDI. Hence, it is often understated. Human Capital refers to the knowledge and competence of the workforce. Skills gained and enhanced through training and experience boost the education and human capital quotient of the country. Once developed, human capital is mobile. It can train human resources in other companies, thereby creating a ripple effect.

**3. Development of Backward Areas**

This is one of the most crucial benefits of FDI for a developing country. FDI enables the transformation of backward areas in a country into industrial centers. This in turn provides a boost to the social economy of the area. The Hyundai unit at Sriperumbudur, Tamil Nadu in India exemplifies this process.

**4. Provision of Finance & Technology**

Recipient businesses get access to latest financing tools, technologies and operational practices from across the world. Over time, the introduction of newer, enhanced technologies and processes results in their diffusion into the local economy, resulting in enhanced efficiency and effectiveness of the industry.

**5. Increase in Exports**

Not all goods produced through FDI are meant for domestic consumption. Many of these products have global markets. The creation of 100% Export Oriented Units and Economic Zones have further assisted FDI investors in boosting their exports from other countries.

**6. Exchange Rate Stability**

The constant flow of FDI into a country translates into a continuous flow of foreign exchange. This helps the country's Central Bank maintain a comfortable reserve of foreign exchange. This in turn ensures stable exchange rates.

**7. Stimulation of Economic Development**

This is another very important advantage of FDI. FDI is a source of external capital and higher revenues for a country. When factories are constructed, at least some local labor, materials and equipment are utilized. Once the construction is complete, the factory will employ some local employees and further use local materials and services. The people who are employed by such factories thus have more money to spend. This creates more jobs.

These factories will also create additional tax revenue for the Government that can be infused into creating and improving physical and financial infrastructure.

**8. Improved Capital Flow**

Inflow of capital is particularly beneficial for countries with limited domestic resources, as well as for nations with restricted opportunities to raise funds in global capital markets.

**9. Creation of a Competitive Market**

By facilitating the entry of foreign organizations into the domestic marketplace, FDI helps create a competitive environment, as well as break domestic monopolies. A healthy competitive environment pushes firms to continuously enhance their processes and product offerings, thereby fostering innovation. Consumers also gain access to a wider range of competitively priced products.

For a multinational corporation, FDI in India is a means to access new consumption and production markets, and thereby expand its influence and business operations. It can gain access not only to limited resources such as fossil fuels and precious metals, but also skilled and unskilled labor, management expertise and technologies. FDI also enables an organization to lower its cost of production- by accessing cheaper resources, or going directly to the source of raw materials rather than buying them from third parties. Often, there are various tax advantages that accrue to a company undertaking FDI. This can occur when the home country allows tax deduction on foreign income, or when the recipient country allows tax deductions and benefits for organizations incurring FDI in that country. Additionally, this can happen when the recipient country has a more beneficial tax code than the home country.

**Disadvantages of Foreign Direct Investment in India**

**1. Disappearance of cottage and small scale industries:**

Some of the products produced in cottage and village industries and also under small scale industries had to disappear from the market due to the onslaught of the products coming from FDIs. Example: Multinational soft drinks.

**2. Contribution to the pollution:**

Foreign direct investments contribute to pollution problem in the country. The developed countries have shifted some of their pollution-borne industries to the developing countries. The major victim is automobile industries. Most of these are shifted to developing countries and thus they have escaped pollution.

**3. Exchange crisis:**

Foreign Direct Investments are one of the reason for exchange crisis at times. During the year 2000, the Southeast Asian countries experienced currency crisis because of the presence of FDls. With inflation contributed by them, exports have dwindled resulting in heavy fall in the value of domestic currency. As a result of this, the FDIs started withdrawing their capital leading to an exchange crisis. Thus, too much dependence on FDls will create exchange crisis.

**4. Cultural erosion:**

In all the countries where the FDls have made an inroad, there has been a cultural shock experienced by the local people, adopting a different culture alien to the country. The domestic culture either disappears or suffers a setback. This is felt in the family structure, social setup and erosion in the value system of the people. Importance given to human relations, hither to suffers a setback with the hi-fi style of living.

**5. Political corruption:**

In order to capture the foreign market, the FDIs have gone to the extent of even corrupting the high officials or the political bosses in various countries. Lockheed scandal of Japan is an example. In certain countries, the FDIs influence the political setup for achieving their personal gains. Most of the Latin American countries have experienced such a problem. Example: Drug trafficking, laundering of money, etc.

**6. Inflation in the Economy:**

The presence of FDIs has also contributed to the inflation in the country. They spend lot of money on advertisement and on consumer promotion. This is done at the cost of the consumers and the price is increased. They also form cartels to control the market and exploit the consumer. The biggest world cartel, OPEC is an example of FDI exploiting the consumers.

**7. Trade Deficit:**

The introduction of TRIPs (Trade Related Intellectual Property Rights) and TRIMs (Trade Related Investment Measures) has restricted the production of certain products in other countries. For example, India cannot manufacture certain medicines without paying royalties to the country which has originally invented the medicine. The same thing applies to seeds which are used in agriculture. Thus, the developing countries are made to either import the products or produce them through FDIs at a higher cost. WTO (World Trade Organization) is in favor of FDIs.

**8. World Bank and lMF Aid:**

Some of the developing countries have criticized the World Bank and IMF (International Monetary Fund) in extending assistance. There is a discrimination shown by these international agencies. Only those countries which accommodate FDIs will receive more assistance from these international institutions.

**9. Convertibility of Currency:**

FDIs are insisting on total convertibility of currencies in under-developed countries as a prerequisite for investment. This may not be possible in many countries as there may not be sufficient foreign currency reserve to accommodate convertibility. In the absence of such a facility, it is dangerous to allow the FDIs as they may withdraw their investments the moment they find their investments unprofitable.