CHAPTER-I
INTRODUCTION

1.1 INTRODUCTION :

Globalization has initiated a sudden surge of FDI inflows to developing countries[1], particularly to countries of South Asia and South East Asia during the past two decades. Even though India has been a latecomer to the FDI scene compared to other East Asian countries, (commonly designated as Emerging market economies) its considerable market potential and a liberalized policy regime has sustained its attraction as a favorable destination for foreign investors.

Foreign direct investment is one of the major devices of attracting international economic integration by any country. Most of the host economies have been using foreign technology to stimulate the pace of economic development, improve efficiency of the domestic companies, augmenting their productivity and creating new opportunities for employment and production. Indian industries need international competition to improve to their efficiency and productivity and for this India needs foreign assistance. Particularly heavy and basic industries need huge amount of investment. This makes the dependence on foreign capital, foreign technology and foreign collaboration all the more imperative. In the modern world the use of latest technology is at the helm of the economic development and economic growth of a country.

There are two sources of technology:

1. Firstly, it could be developed within the country through basic R&D infrastructure and in its evolutionary process, new innovations are brought in.

2. Secondly, technology can be obtained from other countries.

See Jadhav 2015 [1] The IMF World Economic Outlook Database classifies countries as advanced economies or emerging market and developing economies based on the percapita income level , export diversification and level of integration into the global financial system.

In most of the cases the second source is the preferred mode of obtaining latest technology for the developing countries. India for a long time has been using foreign collaboration as its development strategy to import technology to enhance its technological capacity and increase the growth rate of the economy. Further FDI inflows are also intended to fill up the gap between actual and desired level of investment by supplementing the deficient domestic investment.

The desire for rapid economic growth is one of the key objectives of the development strategy of all developing countries including India. It is here that Foreign Direct investment has a larger role to play. In fact, it is one of the oldest and most recognized channels for importing not only technology but also provides access to the export market. In this connection it is pertinent to note that Multinational Companies (MNCs) are the main conduit for FDI. They have large internal market which can be accessed by affiliates. They also control a large market in related areas, because of their 'Brand Values'. Thus FDI has a number of spillover benefits in terms of enhancement of export, employment generation improving productivity and bridging savings & foreign exchange gap. In lines with this the government attitude towards FDI in India has been to encourage setting up joint ventures in India in collaboration with local firms.

This policy has been guided on the basis of the following assumptions

1. Equity capital from abroad can be a source of financing of CAD (Capital Account Deficiency).

2. Joint Venture can overcome the problem of the creation of the monopoly power.

3. Technical collaboration through FDI can facilitate transfer of technology, skills, know how etc. with a view to raise productivity & economic growth.

1.2 HISTORY OF FDI IN INDIA :

It is important to point out here that though a conscious attempt to attract FDI was initiated only after implementing economic reforms in 1991 but foreign capital was not a new notion/approach for Indian economy. India has always had a mystical effect on the foreigners. Since the ancient times, India has been the sole producer and served as a trading ground for agricultural produce, spices, minerals and natural resource, etc. the reason why many of the traders and merchants from all over the world came to India to invest in the enchanting glory of the booming economy and initiate lucrative deals. Merchants from countries like Britain, France, Denmark, Spain, Iran, etc. came to India to set up their trading base. The East India Company of Great Britain which eventually established its political rule over India had actually come as a trading company. This is how the concept of foreign direct investment in India has been known from the earlier times.

At the time of British Rule, large volume of foreign capital in India had been invested in railways, banking, insurance companies, irrigation projects, coastal shipping, trade, mines, iron and steel industry, tea estates, jute mills, cotton textiles, and so on. India’s well built transport system, huge irrigation projects and flourishing industries are being credited to foreign capital. The other side of the picture was however not so bright, as the British government moulded the trade related policies to suit their own interest, suppressed political consciousness and ruthlessly exploited India’s natural resources. All these took place due to the entrance of foreign capital and dependence on foreign capital of Indian economy during pre-independence days. Nevertheless this led to the formulation of strategic policies to create a self reliant and self dependent economy post independence. Challenged by severe balance of payment problems the government of India was forced to implement a set of economic reforms in the year 1991.

1.3 INDIA'S DEVELOPMENT STRATEGY :

India was a latecomer to economic reforms although the need for a policy shift had become evident much earlier as many countries in East Asia achieved high growth and poverty reduction through policies which emphasized greater export orientation. In the 1980s, India took some steps in this direction of export orientation and encouragement of the private sector. but it was not until 1991 that the government signaled a systemic shift to a more open economy with greater reliance upon market forces, a larger role for the private sector including foreign investment and a restructuring of the role of government[2].

Since 1991 in the wake of Balance of Payment crisis, India has embarked on the path of reforms to address Balance of Payment crisis, the structural short coming in the country. As a part of these reforms external sector liberalization (including exports and imports) was initiated pertaining to liberal attitude towards FDI. Over the years the import liberalization measures have been an important component of India's development strategy. The reason behind import liberalization policy is to internationalize the production process as measured by import intensity of exports. Exports are necessary to enhance economic growth through earning foreign exchange reserves. Necessity to import in order to produce for export is an integral feature of international economic integration and globalization of production. Availability and accessibility of imported raw materials and technology may have a significant impact on quality and cost of production and so on. It was believed that the imported raw materials should improve the international competitiveness of exports through cost reduction and generate competition for the domestic suppliers. The import of plant and machinery is supposed to allow the access to advanced technology and larger scale of production.

[2] Montek Singh Ahluwlia -Economic Reforms in India since 1991: Has Gradualism Worked?

Thus liberalizing foreign direct investment was another important aspect of reforms in India, driven by the belief that FDI would increase the total volume of investment in the economy, improve production technology, and increase access to world markets. The policy now allows 100 percent foreign ownership in a large number of industries and majority ownership in all except banks, insurance companies, telecommunications and airlines. Procedures for obtaining permission are enormously made easier by listing industries that are eligible for automatic approval up to specified levels of foreign equity (100 percent, 74 percent and 51 percent). Foreign investors who are interested in investing within these limits only need to register with the Reserve Bank of India. For investments in other industries, or for a higher share of equity than is automatically permitted in listed industries, applications are considered by a Foreign Investment Promotion Board that has established a track record of speedy decisions[3]. Also since 1993, foreign institutional investors were allowed to purchase shares of listed Indian companies in the stock market, thus opening a window for portfolio investment in existing companies widening the area of obtaining foreign capital.

One of the sectors which were thrown open for foreign collaboration was the 'Automotive Industry'. The automotive sector in the Indian industry is one of the high performing sectors of the Indian economy.

This sector has contributed largely in making India a prime destination for many international players in the automotive industry who wish to set up their businesses in India. The automotive sector in India was opened up to foreign investments in the year 1991. Automotive industry allows 100% FDI through automatic route in India. The liberalization of government policies regarding FDI in the automotive industry of India has increased thescope of this industry.

[3] Montek SinghAhluwalia-Ex deputy chairperson planning commission, India

The first FDI player in the Indian automotive sector was Suzuki. In 1980s this company entered into a joint venture with Maruti Udyog a government run enterprise. In the year 1993, FDI was also allowed in the passenger car segment. Today India is emerging as one of the world's fastest growing passenger car markets and the second largest two wheeler manufacturer. It is home for the largest motor cycle manufacturer and fifth largest commercial vehicle manufacturer. The industry is producing about 13 lakhs passenger vehicles, 4 lakhs commercial vehicles 76 lakhs two wheelers and about 3 lakhs tractors per annum. The automobile industry has reached a turnover of US $ 28 billion and the auto component, which is an integral part of automotive industry, has registered a turnover of almost US $ 3 billion.

In order to further improve the automotive industry in the Indian domestic market, to provide world class facilities of automotive testing and certification and to ensure a healthy competition among the manufacturers at a level playing field, the ministry of automobile has undertaken to lay down the road map for future development of the industry in the form of 'Automotive Mission Plan 2006-2016'[4].The Government is of firm conviction that the aspirations unfolded in the mission document will be achieved and Indian automotive industry will attain the strength to meet the competition at world level and came up as a world class industry. The mission Plan would be a useful blueprint for the future to provide the joint vision of the ministry and the Indian Automotive Industry.

1.4 WHAT IS AUTOMOTIVE INDUSTRY? :

The automotive industry is a wide range of companies and organizations involved in the design, development, manufacturing, marketing, and selling of motor vehicles. It is one of the world's most high achieving sectors by revenue. Further the industries which are dedicated to the maintenance of automobiles following delivery to the end-user, such as automobile repair shops and motor fuel filling stations are not included in the automotive industry. Automotive industry also includes most components, such as

[4] see, Automotive Mission Plan '2006-16'

engines and bodies, but excluding tires, batteries, and fuel. The industry's principal products are passenger automobiles and light trucks, including pickups, vans, and sport utility vehicles. Commercial vehicles (such as delivery trucks and large transport trucks, often called semis), though important to the industry, are secondary[5].

The key business of automotive industry is to produce and sell the above mentioned self powered vehicles. This helps in expediting and simplifying the process of commuting by passengers or consumers for work, travelling, shopping and entertainment. This industry also initiates the development of extensive road system, which adds to the growth of suburbs and various shopping complexes and malls etc.

1.5 WHAT IS FOREIGN COLLABORATION ? :

1. In General, this is a cooperative agreement of two or more parties to work jointly towards a common goal. Foreign collaboration is an alliance incorporated to carry on the agreed task collectively with the participation of resident and non-resident entities the involved parties may or may not have had any previous relationship. Alliance is union or association formed for mutual benefits of parties.

2. In Knowledge management (KM), collaboration is a key tenet of KM. This is essential to generating and maintaining a competitive advantage as the effective method of transferring 'know how' to a team of individuals.

3. In negotiations, this is a conflict resolution strategy of using both assertiveness and cooperation to gain solutions worthwhile to all parties. It succeeds best when the interaction among them is directed at attaining common goals and where participants' goals are compatible.

[5] John Bell Rae- Professor of the History of Technology, Harvey Mudd College, Claremont, California, 1959–76. Author of *American Automobile Manufacturers: the First Forty Years* and others.

In finance the foreign collaboration has been defined as-

Foreign collaboration includes ongoing business activities of sharing information related to financing, technology, engineering, management, consultancy, logistics, marketing etc. which are generally offered by a non resident (foreign) entity to a resident (domestic or native) entity in exchange of cheap skilled and semi skilled labour, inexpensive high quality raw material, low cost high tech infrastructure facilities, strategic geographic location and so on , with an approval from a governmental authority like the ministry of finance of a resident country.

It is against this backdrop that the present study makes an attempt to analyze the impact of foreign collaboration on Indian economy, with the case study of automotive sector of Indian economy.

1.6 FDI POLICY AND THE INLOWS OF FOREIGN CAPITAL IN INDIA :

The pro FDI policy of the government provides a thrust to FDI flows in the country.FDI enjoys high priority in the list of government strategy of development. India started as a humble global FDI player in 2000. She is now the world's thirteenth largest FDI host country. In 2008 the inflows of US$ 42 billion was registered in the economy and in 2009 it was 27 billion US$. The continuous comprehensive FDI policy reforms and the growing GDP, domestic demand, competitive labour force and factor market are the other main growth drivers of foreign direct investment in India. Most of the countries particularly developing countries are competing with each other to attract foreign capital to supplement and enhance their domestic rates of investment, acquire new technology and managerial skills. Transition economies are leaving no stone unturned to attract the foreign investors by offering facilities such as repatriation of profits, tax concessions and other incentives. However foreign investments are not foolproof, they have their share of negativity as well. This calls for caution on the part of the government in developing countries to decide carefully the terms and conditions pertaining to sectoral caps, repatriation and tax concession. FDI norms were further liberalized after September 2012 in sectors like civil aviation, power exchanges and retail. The Ministry of Finance has also suggested modifications in FDI caps for various sectors including tea, media, natural gas and petroleum. Again the government made some radical changes from July 2013 to September 2013, in order to make the policies related to telecom, civil aviation, insurance more transparent.

1.7 OBJECTIVE AND HYPOTHESIS OF THE STUDY

Multinational enterprises (MNEs) have become one of the key drivers of the world economy. Today developing countries account for almost one third of the global stock of inward FDI compared to slightly more than one fifth in 1990.The increased role of FDI in developing and emerging economies has raised expectations about its potential contribution to their development. As mentioned earlier FDI is capable to bring significant benefits by creating high quality jobs and introducing modern production and management practices. The increased influence of OECD-based MNEs in Automotive sector of India is particularly striking. The main objective of the present study is to analyze the impact of FDI in India with special reference to automotive sector. The other objectives are:

1. To analyze the sources of FDI into India: As domestic capital is inadequate to meet the purpose of economic growth it s important to know the sources of FDI i.e. the Multinationals which invests in our country.

2. To overview the policy changes which have evolved over a period of time.

3. To find out the correlation between FDI and Economic growth. To investigate whether foreign direct investment has contributed to the economic growth of our economy by examining the various spillover gains.

4. To explore the balance of payment effect of FDI in India.

5. To examine the impact of FDI on productivity and R&D (Research and Development) of firms and industries.

Based on these objectives, the hypotheses of the present study are as follows:

1. FDI firms contribute more towards economic growth than the Non FDI units.

2. Export performances of FDI units are better than Non FDI units.

3. R & D efforts of FDI units are better than Non FDI units i.e. to say that FDI units are more R&D intensive as they spend more on research and development.

4. Automotive sector performs better than other FDI and non FDI units in terms of productivity, R&D and exports.

1.8 TIME PERIOD OF THE STUDY :

For the present study a period between 1991 to 2014 has been considered. The long stretch of the time period facilitates to study effects of FDI on Indian economy in general and automotive industry in particular. Further this entire stretch of time period was divided into two parts i.e. 1991-00 and 2001-14 to capture in detail the impact of various factors including policy changes implemented over the period of time on FDI inflows in India. .

1.9 JUSTIFICATION OF THE STUDY :

The main justification for undertaking this study is that very less detailed examination of the impacts of FDI on Automotive Industry has been undertaken in India. Although a large body of literature exists on the impacts of FDI on Economic Growth, such studies have been undertaken in isolation pertaining to a particular sector or a particular area. This study takes a comprehensive approach to understand the effects of FDI in context of economic growth, trade and R&D activities of various units in general and automotive sector in particular in India, thus providing a wider perspective in terms of coverage of area. It is to overcome this lacuna of earlier studies that the current study was undertaken.

1.10 METHODOLOGY AND SOURCES OF DATA :

Three different methodologies have been applied to test three areas i.e. effects of FDI on economic growth, trade effects of FDI (BOP effect)and effect of FDI on R&D intensity of domestic firms.

For analyzing the effect of FDI on economic growth multivariate regression analysis has been done where FDI is the main variable along with four other variables. These are Gross Domestic Product growth rate (GDP growth rate, Gross Capital Formation (GCF), Trade openness (TO) and Secondary school enrolment (SEC, ENRL). The effect of these variables on the GDP of India has been analysed. Details of the methodology is given in chapter five.

Foreign Direct Investment influences the balance of payment position of a country in two different ways firstly through the finance (capital) flows association with it i.e. equity flowing into the country v/s dividend, royalty, and technical fees etc. flowing out of the country. In addition to this trade account effect of its operation i.e. the exports it generates v/s imports it uses in its production process are also taken into account. The first one can be treated as direct BOP effect and the latter along with the direct effect can be treated as the overall effect. Details of the methodology is provided in chapter six.

For calculating Total factor productivity (TFP) following equations has been used:

TFP = Sales/ W+TA

The capital intensity is calculated in terms of ratio of fixed assets to the total wage bill (FA/W).This shows the requirement of fixed assets per unit of wages and salaries.

The profitability is indicated in terms of ratio of profit before tax to the total assets. (PBT/NFA)

For evaluating the relationship between foreign technology and R&D following methodology has been applied:

$Rd_t = f\ (IT)_{t.}$ Detail of the methodology applied for testing TFP, Capital intensity and profitability have been provided in chapter seven.

R&D intensity of automotive, non FDI and all FDI firms in India have been compared. The R&D intensity is calculated as a ratio of reported R&D expenditure to the value of sales for the period 1991-2013 from the financial statistics provided by different RBI survey reports.

To examine the impact of FDI inflows time series data has been used covering the period from 1991 to 2013. The secondary data for examining the economic growth effect in the present study is taken from World Development Indicators (WDI) published by World Bank. The WDI includes variables such as GDP, per capita GDP, GNI, FDI per capita FDI, GCF as percentage of GDP, trade of goods and services, exports and imports, domestic capital formation, school enrolment, Gross Fixed Capital Formation, Gross national expenditure etc. This is considered as a reliable source of data pertaining to any country of the world. Data published by CMIE Prowess is the principal source of data for understanding the trade intensity and R&D effects. CMIE provides data of the financial performance of Indian companies. Basically it provides the annual reports of individual companies. It presents several well formatted analytical tabulations that include ratio analysis, funds – flow analysis, benchmark and peer comparisons. Data have also been taken from the data base of ACMA the nodal agency for the Indian Auto Component Industry. It represents 700 companies, which contributes more than 85% of the total auto component output in the organised sector. The surveys done by the RBI have also been considered for collecting data. These surveyed data are published in the monthly bulletin of RBI. By comparing the inflows and outflows of FDI during different years an attempt has been made to capture the BOP implication of FDI on Indian Automotive industry.

1.11 CHAPTER SCHEME :

Chapter I the introductory chapter describes the back ground, objectives and significance of the study. It also explains the objectives, the hypothesis to be tested, sources of data and methodology to be adopted. It also provides the justification for undertaking the study.

Chapter II surveys the available literatures. In this chapter comprehensive review of literature pertaining to effects of FDI on economic growth, trade, R & D activities on firms and on productivity of local firms has been done. Further the review of literature has been done from two perspectives, first studies conducted outside India and second studies conducted in India have been reviewed. This has been undertaken to provide justification for the present study.

Chapter III provides an overview of government policy towards FDI in India. In the first section of this chapter the FDI policy in general has been discussed. This section is further subdivided into two sub parts (i) in the first sub -section evolution of the FDI policy in India since its independence has been discussed (ii) in the second sub-section the post reform scenario particularly to FDI has been discussed. In the second section the automotive policy of the government of India has been discussed. This section is also divided into two parts, the first section deals with the evolution of the automotive policy of the government since independence, while the in the second part on-going automotive policy and automotive plan of the government of India have been explained.

In **Chapter IV** an attempt has been made to present the profile of Foreign Direct Investment (FDI). This has been done in two parts. In the first part Profile of Foreign Direct Investment in India has been presented which includes (i) trends and pattern of FDI inflows in India since 1991(ii) country wise inflows of FDI in India (iii) state wise FDI inflows in India (iv) sector wise inflows of FDI in India. The second part includes (i) profile of automotive industry in India, which includes domestic sales, production and exports trends (ii) key elements of automotive industry (iii) opportunities in automotive industry (iv) FDI inflows in automotive industry of India (v) Growth prospects of automotive industry in India.

Chapter V analyses the impact of FDI on Economic Growth. The analysis of the impact of FDI on the economic growth of Indian economy in general and automotive industry in particular has been attempted in this chapter. As per the results it seems auto FDI has presented a better correlation with economic growth in India as compared to overall FDI.

In **Chapter VI** an attempt has been made to find out the trade effects of FDI companies on Indian economy in general and automotive industry in particular, in order to ascertain whether foreign direct investment has enhanced the export intensity of the companies which have received them. The results show that the export intensity of other FDI firms is low as compared to automotive industry in India and that they have not significantly contributed to reduce the country's current account deficits, it also found that the import of cross border scientific and technological cooperation is consuming much of India's foreign exchange reserves.

In **Chapter VII** the effect of technology import on productivity and R&D efforts of automotive firms, other FDI firms, non FDI firms have been analysed. The result shows that there exists positive relationship between local R & D and imported technology. The marginal propensity to invest in R & D in comparison to technology import is greater for automotive firms compared to other foreign firms. The study also unravels another aspect that shows that non FDI firms are also highly R&D intensive, this may be due to the necessity of remaining technologically competitive and face the competition in the market.

Chapter VIII describes the findings and conclusion. It provides necessary policy implications.