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A descriptive study on Economic Reforms, FDI and Economic growth in India

Dr.Biswaranjan Parida, Ms. Bhagyashree Padhi
MBA Dept., Gandhi Institute for Technology
MBA Dept., Gandhi Engineering College

Abstract: *The major concern of the world economy in general and Indian economy in particular is to maintain the growth momentum which has been derailed after the global economic meltdown. So far as economic reform is concern, India has kicked started this in the year 1991 and since then there is no let off in this process. Foreign Direct Investment is one of the key areas which have been included in the reform agenda as there is a positive linkage between FDI and economic growth. Though there is a positive relation between FDI and growth, yet the effect of FDI on economic growth is not as per the expectation. However, there is a positive change in major macro economic variables due to large inflow of FDI after economic reforms.*
Key Words: *Foreign Direct Investment, Economic Reforms, GDP,*

I. Introduction

'Beyond the initial macroeconomic stimulus from the actual investment, FDI influences growth by raising total factor productivity and, more generally, the efficiency of resource use in the recipient economy. This works through three channels: the linkages between FDI and foreign trade flows, the spillovers and other externalities vis-à-vis the host country business sector, and the direct impact on structural factors in the host economy.' OECD

The Indian Economy was in the cross road in the 1990s as it has been suffered from a huge economic crisis when almost all macroeconomic indicators were not beyond the control of the Government. Even the Country was unable to sustain its economy without the immediate assistance from the IMF. As a consequence, the then PM.P.V.NarasimhaRao and FM Dr. Manmohan Singh approached IMF to release US$7billion to restore the Indian Economy. However, the IMF, on the other hand, put a condition before releasing the amount that India should immediately change its economic structure by introducing structural adjustments programs. Therefore, the Government introduced a drastic economic reform program in form of LPG policy. At the same time, the evolutions of global economy after 1990s had been strongly affected the dynamic of FDI and the impact of foreign capital flows on economic development. Therefore, theforeign investors get attracted to Indian economy after government of India introduced the economic reforms program in the year 1991. Consequently, India received FDI to the extent of US$180,034 million from 1990-91 to 2009-10.

The role of FDI in the economic development of an economy emerges when domestic investment is not sufficient to bridge the gap between the desiredand the actual level of capital stock. So it is the FDI that bridges the gap between these two.Apart from this, FDI also brings in better technology and management practices to the host country,which make the economy more competitive through spillover effects. Besides, FDIcan also substitute international trade and hedge the risks of exposure to foreignexchange. The Indian economy get benefitted from the new economic policy 1991 when the limits of foreign investment increased in high priority industries and some industries got eligible for automatic route of FDI. Later on there has been a sea change in the FDI and foreign trade policy which led the economy to a comfortable position in foreign exchange reserve. However, the matter of concern is that, due to liberalization, there was a competition (location tournament) among the states which led to a large scale inequitable distribution of FDI and imbalance growth among them. In order to attract FDI, even many of them offer tax incentives, low cost land and other public utilities at lower price to increase their bargaining power. In consequence, they incur huge administrative and promotional costs than benefits obtained from this. The location tournaments among states seem to have significant implications for wide interstatevariations in FDI inflows that have made the distribution highly skewedtowards a few states (Chatterjee et al. 2009). Interestingly, during April 2000 to May 2009 the top five states including Maharashtra, Delhi, Karnataka, Gujarat and Tamil Nadu had attracted more than 65 percent of total FDI inflows. Whereas, states like Bihar, Madhya Pradesh, Rajasthan and Uttar Pradesh could attract very small portion during the same period. Hence, there is a need to develop the basic infrastructure for obtaining the best benefit from the economic reforms program in general and FDI in particular.

Factors responsible to attract FDI

Though economic reforms is the panacea for growth and development of an economy yet, it will confer best results if there will be a conducive business environment with all provision of social and physical infrastructure. The following are some of important areas that India need to give focus for receiving best results from the economic reforms program as well as foreign investment.

Research and Development Intensity (RDI)

The economic development of any country rests on quality human resource and the quality human capital depends on development in higher education, technology and Research and Development. Again, higher R&D result in greater FDI inflows especially FDI in form of merger and acquisitions. So the states with greater R&D will likely to attract more FDI.

Domestic Investment (DI)

The asset base of a developing economy depends on foreign investment, yet domestic investment plays significant role as it creates infrastructure and market opportunities to encourage foreign investors to invest therein. It isa signal of better business environment and is complementary but not competitive to foreign investment.

Transportation and Communication Infrastructure (TCI)

In order to make the business environment more conducive and provide easy and quick access to input and output market, transport and communication facilities should be developed at priority basis.Hence, the states with better TCI are likely to attract greater FDI inflows(Kumar, 2002; Archana, 2006; Nunnenkamp and Stracke, 2007). This positive association is confined to Green Field investment but not to be applicable in case of FDI comes through merger and acquisitions and developing of infrastructure.

Power Supply (PWR)

In contemporary business world, continuous supply of electricity plays the instrumental role in the industrial development. It has been observed that the states with more power shortage are likely to receive less FDI inflows. However, it may not be applicable to those FDI where the foreign investors develop their own source of power. The study undertaken by Nunnenkamp and Stracke(2007) do not find power supply as a significant determinant of FDI in Indian states. The role of power supply on FDI inflows, therefore, depends on the relativestrength of these diverse forces.

Educational Infrastructure (EDUI)

Education is one of the most vital components of Social Overhead Capital (SOC) and indicator of Human Development Index (HDI). It is the basis of economic development and the country which is good at education attracts more foreign investment. A number of research works (e.g., Noorbakhsh et al. 2001; Quazi, 2007; Nunnenkamp and Stracke, 2007) have been conducted on this subject and found the positive correlation between educational infrastructure and FDI inflows. However, as qualitative manpower is highly mobile and needed for highly skilled industry, semi-skilled or unskilled work force at the local level is more instrumental for investment decision by the foreign investor as they supply labor at low cost.

Health infrastructure (HI)

The productivity of labor has got direct link with the life expectancy and conducive health conditions as the low expectancy rate is the cause of loss of wealth of nations. It is one of the factors that attracts foreign investment and fosters economic development(Sen and Pal, 2005). Therefore, one may expect a positive relationship between health infrastructure and FDI inflows.

Risks of Investment (RI)

The major obstacle to the contemporary business is market risk as the potential investors are always risk averse and select investment location where risk is less (Moosa, 2002). It is a well known fact that firm gets more return on investment with minimum risk factors. Therefore, higher risks reduce the likelihood of entry unless the potential entrant is risk prone(Basant and Saha, 2005). Greater risks also restrict expansion of the existing firms. So there is an inverse relation between Market risk and inflow of foreign investment.

Objectives of the study

- To analyze the importance of Economic Reforms in India
- To investigate the correlation between Economic reforms and inflow of FDI
- To find out the link between FDI and macroeconomic variables

Hypothesis
$H1_0$= There is no positive linkage between Economic Reforms and change in the macro economic variables
$H1_1$= There is a positive linkage between Economic Reforms and change in the macro economic variables
$H2_0$= There is no positive correlation between Economic Reforms and inflow of FDI to India
$H2_1$= There is a positive correlation between Economic Reforms and inflow of FDI to India
$H3_0$= FDI has not made any drastic change in the economic growth of the Indian economy.
$H3_1$= FDI has made a drastic change in the economic growth of the Indian economy.

II. Data Source &Methodology

The present study shall make use of secondary sources of data collected from the sources like RBI Bulletin, Economic Survey, DIPP report, Journals, news papers and etc. The reference period of this study relates from 1991 to 2011.

Relevant statistical techniques, especially Regression, have been used in the study along with ANOVA and Ratios. The question about the growth pattern of Indian Economy to FDI is whether of India undergoes a structural change after new economic policy- 1991 and Financial Crisis 2008. The following regression equation can be taken to show the link between the independent and dependent variables.

$z = f(x_1, x_2, x_3 \ldots\ldots\ldots\ldots\ldots.. x_n)$

Where, Z is independent variable & it stands for FDI and
X_1= Gross Domestic Product at factor cost (GDP_{FC})
X_2= Gross Domestic Capital Formation (GDCF)
X_3 = Export (EX)
X_4= Import (IM)
X_5= Foreign Exchange Reserve (FER)

III. Review of Literature

Review of various literatures available on economic reforms, FDI and growth of an economy reveals that the link between these three is still a matter of debate. Opinions are still divided. FDI has its own advantages and disadvantages. Many scholars argue that through FDI developed nations may try to invade the sovereignty of host country. In order to earn quick profit they may exploit the natural resources at the faster rate and thus leave the host country deprived in the long run. Some of the studies have shown their concern that FDI is a big threat to survival of domestic players. Many are of the opinion that basic objective of foreign investments is to earn profits by ignoring the overall social & economic development of the host nation. However, most of the studies agree that FDI is necessary for sustained economic growth and development of any economy in this era of globalization.

Singh et al 2012 find out Foreign Direct investment flows aresupplementing the scarce domestic investments in developing countries particularly in India. They recommend that India should welcome the inflow of foreign investment because it enables India to achieve the cherished goal like making favorable balance of payment, rapid economic development, removal of poverty, and internal personal disparity in the development and also it is very much convenient and favorable for Indian economy.Sahoo (2004), the major findings of his study at macro level suggests that FDI played a vital role in the economic growth of the country and for major contribution in the capital formation.Chakraborty and Nunnenkamp, 2008 went for a study on the changing structure, composition and growth of FDI in India by using the industry specific FDI and output data and applying a panel co-integration frame work that integrates long term and short term dynamics of FDI-growth relationship.Chatterjee et al (2013) attempted to identify the factors that contribute to the wide-scale variations in FDI inflows across Indian States. The study revealed that infrastructure does not have significant impact on inter-state variations in FDI inflows, which is contradictory to the general perception that availability of infrastructure facilities largely determines the locations of investment projects.Aggarwal (2013) investigated the sensitivity of FDI to labor market conditions of 25 Indian states with time series data of 11 years (1991-2001). The study suggested that infrastructure and regional development induces higher FDI both in exports and domestic market sectors.Rastogi and Sawhney (2013) examined the pattern of inward FDI at the disaggregated industry level and tried to test the causal relationship between industry specific characteristics and inflow of FDI in India during 2000-10. The study found that the FDI inflows are significant in capital intensive industries with very high growth rate. Chakrabarti and et al (2012) made a finest study on the relationship between physical and financial infrastructure and FDI in 600 districts of India from 2002 to 2007. By using panel regressions, they found that there is a positive relationship infrastructure and FDI inflow. Ray (2012) by using Least Square Method found that there is there is a positive relation between FDI and GDP in India. Through Granger Causality Test it was found that there is a presence of unidirectional causality between economic growth and FDI. CARP (2012) tried to find the importance of FDI flows and host country economic growth in which it was observed that the impact capital flows exert on host country is significant and the main channels through the

effects are transmitted are financial markets, host country absorptive capacity, human capital and technological. Chakraborty and Nunnencamp (2006) revealed that the FDI stocks and output are mutually reinforcing in the manufacturing sector, transitory in service sector but absent in agriculture sector.

FDI INFLOWS IN POST-REFORM PERIOD SINCE 1991

The economic reforms programme has had large scale impact on the inflow of FDI and so also in the industrial development in India in terms of bringing greater competitiveness and efficiency and also modernization, technological up gradation, creation a sound base for export promotion and above all integrating India with rest of the world. All these changes were possible due to following steps taken by the Government.

- Foreign investment promotion board (FIPB) was established and has been authorized to provide a single window clearance for all project proposals regarded by it.
- Introduction of the dual approval system for FDI proposals viz. (i) through an automatic approval channel for FDI in 35 priority sectors by RBI up to equity participation 51 percent and (ii) through formal government of India channel via FIPB/SIA.
- Existing companies were allowed to hike their foreign equity up to 51 percent in priority sector.
- Dilution of dividend balancing conditions and its related exports obligation except in case of 22 consumer goods industries.
- Removal of restrictions of FDI in low technology sectors.
- Automatic permission for technology agreement in high priority industries.
- Removal of condition for FDI with necessary technology agreements etc.

Apart from these in August 1999 the government of India set up Foreign Investment Implementation Authority (FIIA) within the ministry of industry to level the progress of immediate translation of FDI approvals into implementation by providing a pro-active one step after care service to foreign investor like helping them obtain necessary approvals and sorting their operational problems. FIIA is assisted by Fast Track Committee which has been established in 30 Ministries/Departments of Government of India for monitoring and resolution of difficulties for sector specific projects. Along with a steering committee on FDI was set up by the planning commission in August 2001 under Chairmanship of N.K. Singh which submitted its report in September 2002 to the Prime Minister. All these policy changes were intended to make India investors' friendly destination for FDI. Due to these initiatives India got a good response from the international communities, though it received a large amount from some specific contributors like Singapore, USA and etc.

However, during this period, many sectors were kept outside the FDI and even the sectors which were permitted for FDI had some limitations in the upper limit. Along with this investors were suspicious about the economic policy changes followed by changes in central government. Despite of all such limitations, India has received total FDI of US$ 180,034million from the year 1990-91 to 2009-10 which is due tothe initiatives taken by the Government of India inattracting FDI inflows in India. The FDI inflows haveshown a rising trend from 1991-92 to 1997-98 owing to thesincere programmes of structural liberalization and open marketreforms. The rise in flows of FDI till 1997 was dueto not only of the liberalization policy but also due to thesharp expansion in the global scale of FDI outflows duringthe 1990s. Another causal factor may have been therecovery of the Latin American economies, which hadbegun to emerge from the Debt Crisis of the 1980s. Thenafter during 1998-99 and 1999-00 there was decline in FDIinflow which was due to the decline in industrial growthrate in the economy and also due to the result of the EastAsian Financial Crisis. But again in the next followingyear, foreign investment started to bounce back. During2002-03 and 2003-04, again there was fall in flow offoreign direct investment which was due to the cast ofGlobal Recession on the Indian economy. The FDI Equityinflows during the five years 2005-06 to 2009-10 showed amassive increase of more than seven times than those of the previous year 1991-92 to 1999-00 and 2000-01 to 2004-05. This increase was due to the revised FDI Policy inMarch 2005, an important element of the policy was toallow FDI up to 100% foreign equity under the automaticroute in townships, housing, built-up infrastructure and Construction projects. The year 2005 alsowitnessed the enactment of the Special Economic ZonesAct, which entailed a lot of construction and townshipdevelopment that came into force in February 2006. However, on account of Global Economic Meltdown, there was big jolt to FDI inflow. As a result, the FDI inflow went down to the negative in the year 2010-11.

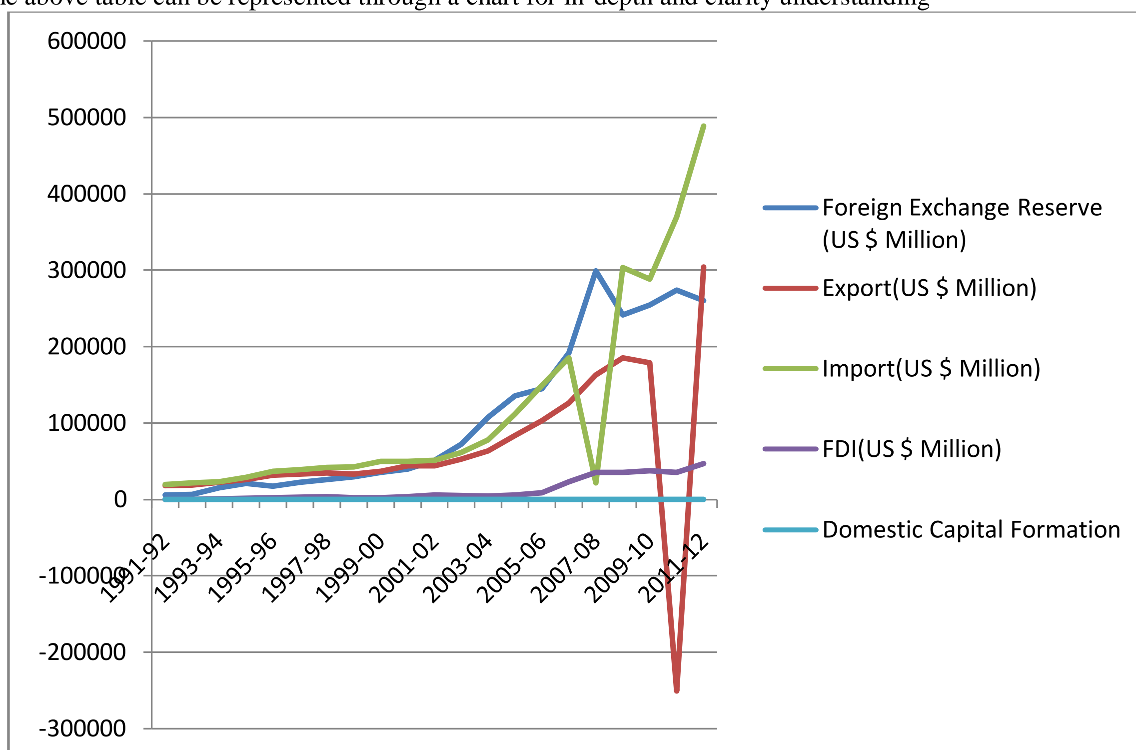
The table 1 shows the changes occurred in the different economic variables after introduction of economic reforms in 1991. It is observed that there is a constant and positive change in all most all variables like Foreign Exchange Reserve, Export, Import, Capital Formation and Foreign Direct Investment barring few years like 1998-99 and 2010-11.

Table1Economic Reforms & its impact on Macro Economic Variables

Year	Foreign Exchange Reserve (US $ Million)	Export(US $ Million)	Import(US $ Million)	FDI(US $ Million)	Domestic Capital Formation
1991-92	5631	17865	19411	129	21.8
1992-93	6434	18537	21882	315	23.0
1993-94	15068	22238	23306	586	22.2
1994-95	20809	26330	28654	1314	24.7
1995-96	17044	31707	36678	2144	25.3
1996-97	22367	33470	39133	2821	23.7
1997-98	25975	35006	41484	3557	25.6
1998-99	29522	33218	42389	2462	24.2
1999-00	35058	36822	49671	2155	26.8
2000-01	39554	44076	49975	4029	24.4
2001-02	51049	43827	51413	6130	24.3
2002-03	71890	52719	61412	5035	24.8
2003-04	107448	63843	78149	4322	26.9
2004-05	135571	83536	111517	6051	32.8
2005-06	145108	103091	149166	8961	34.7
2006-07	191924	126414	185735	22826	35.7
2007-08	299230	163132	21654	34835	38.1
2008-09	241426	185295	303696	35180	34.3
2009-10	254685	178751	288373	37182	36.5
2010-11	274330	-251136	369769	34847	36.8
2011-12	260069	304624	489181	46556	35.0

Source: Economic Survey, RBI bulletin, DIPP

The above table can be represented through a chart for in-depth and clarity understanding



From the above figure, it is observed that economic reform has mixture of impact on macro economic variables. Though there is a significant change in the Foreign Exchange Reserve, yet there a huge gap between export and import which led to large current account deficit. So far as FDI is concern, India could not attract much in comparison to China and other developed countries. There is an insignificant change in the gross capital formation.

However, it is a verified fact that India got huge response from the international communities with regard to FDI flow. In fact, apart from this, it received many spillover effects of FDI in other macro economic variables like Gross Domestic Production, Gross Domestic Capital Formation, Foreign Exchange Reserve and percentage change in export and import. The table -2 reveals the impact of FDI on these macro economic variables.

Table-2 Effect of FDI on major economic variables

Year	Domestic Capital Formation	Foreign Exchange Reserve (% growth)	Export(% growth)	Import(% growth)	$GDP_{FC\ (\%)}$	FDI % growth
1991-92	21.8	369.25	-1.5	-19.4	1.4	33
1992-93	23.0	14	3.8	12.7	5.4	144
1993-94	22.2	134	20.0	6.5	5.7	86
1994-95	24.7	38	18.4	22.4	6.4	124
1995-96	25.3	-18	20.8	28.0	7.3	63
1996-97	23.7	31	5.3	6.7	8.0	31
1997-98	25.6	16	4.6	6.0	4.3	26
1998-99	24.2	14	-5.1	2.2	6.7	-30
1999-00	26.8	19	10.8	17.2	7.6	-12
2000-01	24.4	13	19.7	0.6	4.3	87
2001-02	24.3	29	-0.6	2.9	5.5	52
2002-03	24.8	41	20.3	19.4	4.0	-17
2003-04	26.9	49	21.1	27.3	18.1	-14
2004-05	32.8	26	30.8	42.7	7.0	40
2005-06	34.7	7	23.4	33.8	9.5	48
2006-07	35.7	32	22.6	24.5	9.6	155
2007-08	38.1	56	29.0	35.5	9.3	52
2008-09	34.3	-19	13.6	20.7	6.7	1
2009-10	36.5	5	-3.5	-5.0	8.6	5
2010-11	36.8	8	40.5	28.2	9.3	-6
2011-12	35.0	-5	21.3	32.3	6.2	34

Source: Compiled by author

Analysis of Result

There is a positive correlation between FDI and other macroeconomic variables as the multiple R is equal to 0.35. The influence of FDI on dependent variable is 12 percent. The standard error is 58.73.

REGRESSION	
Multiple R	0.35
R Square	0.12
Adjusted R Square	-0.19
Standard Error	58.73
Observations	20

ANOVA					
	df	SS	MS	F	Significance F
Regression	5.00	6752.68	1350.54	0.39	0.85
Residual	14.00	48291.70	3449.41		
Total	19.00	55044.39			

The ANOVA result shows there is no significant difference between FDI and other economic variables. This is indicated though the regression analysis where the percentage of influence is very low i.e.12 percent only. So it is concluded that the dependent variables like Domestic capital formation, Export, Import, GDP growth are not highly influenced by FDI after the economic reforms programme is undertaken.

IV. Conclusion

There is no doubt in the fact that economic reforms have had a lasting impact and spillover on the different macro economic variables starting from GDP growth to FDI inflows. However, the relative growth is much less than expectation as it lies on many factors like good business environment, physical and social infrastructure. The most important factor is the smart, stable and conscientious government with concrete economic policy. Under this circumstance, it is the responsibility of the government of India to repeal those legislatures that will help to attract the foreign investment in a large way. So, India under the leadership of PM Mr. NarendraModi, will likely to take utmost priority to eradicate all the bottlenecks on domestic and foreign investment in order to optimize benefits from the economic reform program.

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