Chapter 14
Incentives to Attract Foreign Direct Investment in Emerging Economies:
A Causality Analysis for the Indian Case

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ABSTRACT

The study delves into a diagnostic check for macroeconomic factors that may cause and explain outward FDI flows to India as a representative of the emerging economies. The seventeen top investing economies to India across the period from 2008-14 reveal that overall FDI outflows, inflation, exchange rate and growth of the economy affect FDI outflows to India in the long run where only exchange rate has a causal effect. Also, the above-mentioned variables except growth along with the size of the economy has significant effect on the extent of FDI flows to India from the economies considered for the study.

INTRODUCTION

Foreign Direct Investments (FDI), a key component of foreign private capital flows, has been an important means to financing investments and growth in the emerging economies. Such inflows often exceed official sectoral financing within the economy and have continued to remain an important engine of growth in a majority of the Emerging Market Countries (EMC) of the current global economy. Foreign private capital flows, and in particular short-term flows, can, however, be unpredictable as is evident from the recent financial crises. In this light, it has become imperative to understand the trends in FDI flows to EMCs. Insights into investment decisions and structural changes that may affect the trends and direction of such flows have become the prevailing pointers in recognising net private flows to emerging

DOI: 10.4018/978-1-5225-2345-1.ch014

markets and can possibly be a source of negotiating economic stability at times of volatility in global capital markets (The World Bank, 2003).

China and India are the largest emerging markets in the current global economy (Jain, 2006). Around the mid-2015, the World Bank estimated that while China was the leading Emerging Market Country (EMC), India will be poised to overtake China with a 7.5 per cent projected growth rate (Times of India, 2015). The World Bank also anticipated that China would grow at 7.1 per cent while other EMCs would grow by 4.4 per cent in 2015, with a likely rise to 5.2 per cent in 2016, and 5.4 per cent in 2017. Although the "carefully managed" slowdown would continue in China, the oil importing Indian economy would move ahead because reforms helped in stimulating the market confidence and falling oil prices reduced economic liabilities (World Investment Report, 2015).

In 2015, the World Bank Chief Economist, Kaushik Basu opined that

… slowly but surely the ground beneath the global economy is shifting. China has avoided the potholes skillfully for now and is easing to a growth rate of 7.1 per cent; Brazil, with its corruption scandal making news, has been less lucky, dipping into negative growth; growth in South Asia is expected to continue firming to 7.1 per cent this year, led by a cyclical recovery in India and supported by a gradual strengthening of demand in high-income countries. (Times of India, 2015)

India's gain from the declining global oil prices has enabled the country to improve its fiscal and trading accounts. Implementation of subsidy reforms and the easing of monetary policy has helped the country raise business and investor confidence, thereby attracting new capital inflows. The "Make in India" initiative since late 2014 has been a vital impetus to the inflow of funds and boosting economic growth (The Economist, 2014).

Regional studies pertaining to Asia submit that India is poised to be the next economic super-power, surpassing China soon (Thirlwell, 2004). Whether this prediction holds any water, is a matter of time. However, it is undeniable that the importance of the Indian economy as a key driver in the global economic growth will remain a force to reckon with (Chandler & Zainulbhai, n.d.) (Asia House, 2013) (Sanghoee, 2015) (Forbes, 2015) (LSE IDEAS, 2012). It is in this light, that the chapter aims to investigate the determinants of inward FDI in India from its highest investing partners.

The chapter is divided into two main parts – a) the importance of India in the global economy and how investment inflows will help the economy grow b) the empirical analysis to understand short run and long run relationships amongst the variables considered and estimate the extent of the effects.

BACKGROUND

In the last few years, the global economy has slowed down considerably. Foreign Direct Investment (FDI) in 2014 recorded a decline of 16 per cent (approximately, 1.2 trillion). The decline has been fraught with economic and geopolitical instability, creating various policy driven uncertainties for investors world-wide; large disinvestments have also off set new global investments. New investments were also offset by some large divestments. The drop in FDI flows was particularly concerning when compared to the global growth in GDP, trade, gross fixed capital formation and employment. However, since 2015, an upward trend in FDI has been noted. In fact, the current FDI flows are responsible for almost 40 percent of external development finance to developing and transition economies. The UNCTAD predicts FDI

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