

**Summary:** Foreign direct investment both into, and out of, India has yet to recover to the levels reached before the global financial crisis. This is despite the country's economic resilience in other areas, and a global rise in FDI flows in many emerging market economies during the post-crisis period. Both formal and informal barriers to investment remain challenges for foreign investors in India, including FDI caps, regulatory delays, inflationary pressures, corruption, and poor infrastructure. Given the importance of such investment for future Indian growth — and relations between India and the transatlantic community — the Indian government should continue to seek regulatory and legal reforms that enable greater FDI flows.

## Foreign Investment in India after the Global Financial Crisis

by Ashley Thomas Lenihan

Indians are rightly proud of the dramatic increase in the level of foreign direct investment (FDI) by Indian citizens beyond their country's borders over the last decade, which has not only increased the profile and stature of the Indian business community, but provided new opportunities for growth, access to technology, and economic expansion. Between 2000 and 2008, outward FDI (OFDI) steadily increased from \$500 million to \$18.5 billion.<sup>1</sup> Since the financial crisis began in 2008, however, Indian OFDI has lost ground: down to \$15.9 billion in 2009, and again to \$13.2 billion in 2010. In comparison, Russian and Chinese outward FDI rose significantly during that same period — by over 18 percent and 20 percent respectively — as these countries took advantage of relatively cheap prices abroad. Given India's resilient economic growth over the last few years, Indians would seem to be breaking the "BRIC mold" by taking advantage of domestic investment opportunities over foreign ones.

However, inward foreign direct investment (IFDI), which also rose dramatically over the years preceding the financial crisis (from \$3.6 billion to \$40.4 billion between 2000 and 2008), has also declined since 2008, decreasing to \$34.6 billion in 2009 and \$23.7 billion in 2010. This at a time when foreign investors, mindful of the global recession, were generally favoring emerging markets with higher risk reward ratios over those in advanced industrial societies. While India's FDI growth rate plummeted between 2009 and 2010 (at -32 percent), it was positive in Russia, China, and Brazil (at 3, 6, and 16 percent respectively). In 2010, FDI into Hong Kong alone (at \$62.6 billion) neared three times that into India, and FDI into the rest of China dwarfed it at \$101.0 billion. Growth rates in IFDI during that same period in Malaysia and Singapore were nearly 410 percent and 123 percent respectively. Thus, once again, India seems to be bucking the emerging markets trend — but this time in a way in which it is more difficult to find a positive explanation. In general, foreign investment flows to India have been volatile in recent years, and have also been low relative

<sup>1</sup> All FDI estimates sourced from *UNCTAD Global Investment Trends Monitor* (Geneva: United Nations Conference on Trade & Development, January 17, 2011); and *UNCTAD Global Investment Trends Monitor* (Geneva: United Nations Conference on Trade & Development, April 27, 2011).

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to the size of India's market and compared to regional peers. According to the *Legatum Prosperity Index*, India ranks only 61<sup>st</sup> out of 110 countries globally in terms of its net FDI size, when controlled for volatility.<sup>2</sup>

## Formal and Informal Barriers to FDI

One of the primary reasons behind the comparatively low levels of IFDI into India is the high number of both formal and informal barriers to foreign investment, which persist as a significant concern for foreign investors despite the Indian government's gradual efforts to open their economy. Though India's government is undertaking gradual reforms to open up its economy, a relatively large number of formal barriers to foreign direct investment remain in place. FDI is completely prohibited in an odd assortment of industries and sectors including (among others) the real estate business, cigarette/cigar manufacturing, the lottery, casinos and gambling businesses, atomic energy, rail and rapid transit transport, and multi-brand retail.<sup>3</sup> A number of industry and sector-specific foreign investment caps also still exist, varying from 74 percent foreign ownership (in industries that range from internet service providers to cargo airlines) to a 20 percent cap (on FM-radio broadcasting services). In some of these cases, investment is automatically allowed up to the capped amount, while in others, prior approval is required by the Foreign Investment Promotion Board (FIPB). The result is a confusing investment landscape that places formal barriers on sectors as different as defense production and insurance, resulting in hesitancy on the part of investors who are either unfamiliar with it or unsure of how to navigate it.

Regulatory delays associated with this process can be prohibitively costly and high-profile delays like those seen in the Cairn-Vedanta deal can send negative signals to other investors. In that case, U.K.-based Cairn Energy was repeatedly forced to push its deadline back for the sale of its subsidiary Cairn India to the mining company Vedanta due to a lengthy government approval process.<sup>4</sup> Announced in August 2010, the deal was not approved until June 2011,

<sup>2</sup> *The 2010 Legatum Prosperity Index* (London: Legatum Institute, 2010).

<sup>3</sup> See *Country Finance Report: India* (New York: Economist Intelligence Unit, July 2010); and *Consolidated FDI Policy: Circular 1 of 2011*, (New Delhi: Government of India, Ministry of Commerce & Industry, Department of Industrial Policy & Promotion, April 1, 2011).

<sup>4</sup> Amy Kazmin, "Cairn Energy Pushes Back Vedanta Date," *Financial Times*, May 20, 2011.

and the company still awaits formal notification from the government. Although Vedanta is owned by Indian entrepreneur Anil Agarwal, it is also a U.K.-based company, and the Indian government appeared wary about approving the sale before an outstanding royalty dispute between the government-owned oil company ONGC and Cairn India was resolved. By dragging on for nearly a year, however, the deal focused negative attention on the unpredictability of the approval process. The comment by Cairn's CEO that investing in India required "the three Ps: positive, patience, and perseverance" is unlikely to help sway the undecided over investing in the Indian market.

More informal barriers to investment can also deter foreign companies. For example, the rupee continues to face inflationary pressure (it remains above 8 percent) and interest rates in India continue to climb.<sup>5</sup> Even the complexity and variety of regional regulations and laws can be difficult to overcome. Such domestic economic factors create uncertainty for foreign actors and act as informal barriers to investment, making the Indian market less attractive compared to some other emerging markets. Similarly, pervasive corruption in India remains a deterrent to foreign investors, who are often unwilling or unable to navigate a license system whose potential for abuse has recently been highlighted in a spate of high-level scandals. In fact, the *Legatum Prosperity Index* shows India to rank 72<sup>nd</sup> (out of 110 countries globally) for the perception within its society that corruption is "widespread in business and throughout government."<sup>6</sup> The *Legatum Institute Survey of Entrepreneurs: India* reports that 91 percent of Indian entrepreneurs think corruption is a problem, and 75 percent believe it to be worse now than previously. Other informal barriers to investment include poor and decaying infrastructure, which limits companies' abilities to transport goods and provide services or reliably access utilities such as water and electricity.

## Investment and the Transatlantic Community

Allowing the greater flow of foreign direct investment into the Indian economy would not only provide economic benefits, but would also strengthen the relationship between India and the members of the transatlantic community,

<sup>5</sup> Prabhudatta Mishra and Pratik Parija, "Food Inflation in India Seen Accelerating as Farmers' Costs, Oil Increase," *Bloomberg*, May 20, 2011.

<sup>6</sup> The data is sourced from the 2009 Gallup World Poll and Legatum Institute calculations. See *The 2010 Legatum Prosperity Index* (London: Legatum Institute, 2010).

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which remain among the largest investors in its economy. FDI leads to “technology spillovers, assists human capital formation, contributes to international trade integration, helps create a more competitive business environment, and enhances enterprise development, all of [which] promote higher economic growth.”<sup>7</sup> And at the moment, the United States, Britain, Netherlands, France, and Germany rank among India’s top investors. In fact, the United States is likely the largest true investor in India after Singapore. (Exact proportions or league tables of foreign national investment in India are difficult to come by, because the tax-haven Mauritius is technically the largest investor in India. Foreign companies from around the world, including the United States, often incorporate there, treating it as a launch-pad for India.) As the most populous democracy in the world, with a growing consumer economy and resilient growth rates, India will long remain an important long-term market for members of the transatlantic community. More importantly, as trade increases between India and the transatlantic community, so will the strength of the relationship between these democracies. This will not only help to build long-term trust between these communities, but will also likely help to increase India’s soft power in the West, and vice versa.

The current Indian government seems to be making tentative steps in the right direction. The Indian Department of Industrial Policy and Promotion, for example, recently released three important discussion papers examining the possibility of allowing FDI into Limited Liability Partnerships (LLPs) in India, lowering FDI caps in the defense production sector, and ending the prohibition on FDI in the multi-brand retail sector. As a result, the government made the positive move to allow FDI into LLPs in early May of this year.<sup>8</sup> And though the debate over the defense sector remains ongoing, recent events indicate that the Indian government is nearing a decision on opening up multi-brand retail to foreign investors. In fact, the Committee of Secretaries gave their approval to the idea on July 22, though the plan faces strong opposition and must still be approved by the Cabinet. It also seems clear that the opening of multi-brand retail will come with certain strings attached, as the proposal includes a degree of state discretion over approval of such investment, geographic

limitations, and a “condition of a minimum investment of \$100 million,” with \$50 million required to be “invested in back-end infrastructure such as warehouses, cold-storage, and transportation.”<sup>9</sup> India is making positive overtures toward opening its country to foreign direct investment. However, it still has a long way to go in terms of breaking down both the formal and informal barriers to investment that currently prevent it from fully reaping the benefits that come from greater integration into the global economy.

<sup>9</sup> “Decision on retail FDI soon,” *The Telegraph* (Kolkata), May 19, 2011.

## About the Author

Ashley Thomas Lenihan is a senior fellow at the Legatum Institute.

## About India Forum

India Forum — an initiative of the German Marshall Fund, Legatum Institute and Sweden’s Ministry for Foreign Affairs — convenes policymakers, intellectuals, journalists, and businesspeople from Europe, the United States, and India twice a year to discuss shared challenges and facilitate cooperation and coordination. For more information on India Forum, go to [www.gmfus.org/cs/asia/india\\_forum](http://www.gmfus.org/cs/asia/india_forum).

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<sup>7</sup> *Foreign Direct Investment for Development; Maximising Benefits, Minimising Costs*. (Paris: OECD, 2002)

<sup>8</sup> Radhika Jain. “Nod for FDI in LLPs,” *Moneycontrol.com*, May 13, 2011.