The Role of FDI in the Exports of India’s Manufacturing Sector

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Abstract

FDI (Foreign Direct Investment) is important for developing countries due to its role of technology transfer, global market access and capital formation, which in turn leads to economic growth. After the economic reforms in 1991, the Indian government started deregulation and liberalization on FDI policy. Furthermore, the current Indian government under the Prime Minister Narendra Modi launched the ‘Make in India’ initiative in 2014 to develop India’s manufacturing sector, in which the importance of FDI is emphasized. In this context, we analyze the role of FDI in the export of India’s manufacturing sector by comparison of two industries, the textile and apparel industry, and the automobile industry. In the case of automobile industry, FDI was allowed in the early 1980s through joint venture with Japanese company in order to develop automobile industry and to enhance exports. Since then, India’s production and exports of automobile have significantly increased. Therefore, it shows that there is a positive impact of FDI on exports in the automobile industry. On the other hand, there is limited impact of FDI on export in the textile and apparel industry because this sector liberalized FDI policy later than automobile sector.

Keywords : India, Manufacturing Sector Export, FDI, Economic Growth

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1. Introduction

Foreign Direct Investment (hereafter FDI) brings a large capital stock as well as advanced technological and managerial skills, which in turn leads to an increase in productivity. Moreover, FDI increases competition in the market, resulting in an improvement in productivity. If this is the case, we can expect an expansion of production and increase of wages in host countries. Multinational companies (MNCs) usually have better access to global markets, directly related to an increase in exports of host countries (Blomstrom and Kokko, 1996; Rădulescu & Şerbănescu, 2012; Shulka, 2013). A case study of China, Zhang (2005), shows that FDI has a greater impact on export performance, in particular labor intensive industries rather than domestic capital. Further, Zhang argued that the role of government in shaping policies of export oriented FDI and in bargaining against MNCs was important in China. Rădulescu and Şerbănescu (2012) also found that FDI had a positive impact on export in Central and Eastern European countries. Therefore, the role of FDI has been increasingly important in economic growth in the developing countries.

In this study, we examine the impact of FDI on exports performance in the case of India. A high economic growth, low labor cost, large population, diversified product spectrum etc. are main factors to attract FDI into India (Singh and Tandon, 2016). Hence, according to A.T. Kearney Foreign Direct Investment Confidence Index, India was ranked eighth in 2017. Moreover, the Indian government launched the ‘Make in India’ initiative in 2014 to develop India’s manufacturing sector, as well as to increase exports of manufactured goods. The Indian government expects that the ‘Make in India’ initiative will bring FDI into India, leading to an improvement in the manufacturing sector and exports.

In this context, it is necessary to examine the impact of FDI on India’s export performance in the manufacturing sector, in particular the textile and apparel industry, and the automobile industries. As India has affluent raw materials and efficient production facilities, the textile and apparel industry is traditionally important in India’s manufacturing sector and export. However, this industry consists of many small and micro sized firms, which are highly protected by government policies, even in terms of FDI. However, India’s automobile industry has received FDI since the early 1980s. India has become the fifth largest automobile producer in the world.

4) http://www.makeinindia.com/about
and India is one of the largest exporter of small sized passenger car. Therefore, we investigate the impacts of FDI on exports in the Indian manufacturing sector by comparing two industries.

As far as I know, there are very few studies to compare these two industries based on FDI and export performance. Hence, this study will contribute towards further study on the Indian economy. The study consists of following. The background and research question are described in the introduction part. The second chapter elaborates a brief background of India’s FDI policy. Analyses of the impact of FDI on export in the textile and apparel industry, and the automobile industry are presented respectively in the third and fourth chapters. The last chapter concludes with a summary of the study.

2. A Brief Background of India’s FDI Policy

From the Independence in 1947 until 1990, the Indian economy was governed by licensing and strict regulations under the Industrial Policy Resolution 1956. In this sense, the Indian economy before the reforms was sometimes described as License Raj. When it comes to external sector, the Indian government emphasized self-reliance in economy; hence import substitution policy with heavy protection and a high rate of tariffs was introduced to encourage domestic production, rather than importing. In the case of FDI policy, the Indian authorities had a restrictive approach, and it became more constrained with the introduction of FERA (Foreign Exchange Regulation Act) in 1973, in which foreign equity holdings were only allowed up to 40 percent and new establishment by foreign company was not allowed (Vyas, 2015). Moreover, FERA consolidated and amended law related payments and foreign exchange transactions, which affected foreign firms’ business in India (Reserve Bank of India, 2005). Therefore, larger sized foreign firms left the Indian market after the implementation of FERA.

Faced with a balance of payment crisis in 1991, the Indian government implemented economic reforms with the purpose of Liberalization, Privatization and Globalization as a part of a bailout program of the International Monetary Funds (IMF). The Indian government announced the New Industrial Policy, in which licensing was deregulated except for 18

5) Based on the Industrial Policy Resolution 1956, socialistic economic growth model was initiated, emphasizing on the public sector. Indian industry was categorized into three based on this policy. Schedule A industries, for example, railways, arms and ammunition, iron and steel, atomic energy etc, was under the domain of government. In the case of industries in the Schedule B, state government was main player but private sector could enter with the government controls. The third, private as well as state could enter the in Schedule C.
6) Raj means kings in Hindi. License Raj is sometimes interchangeably used as Permit Raj.
industries. At the same time, trade and FDI were also liberalized. In the foreign trade regime, the Indian government relaxed import licensing, reduced tariff rates and provided incentives to increase exports. Tariff rates decreased to 39 percent in 1995 from 80 percent in 1990, while non-tariff barriers also fell from 87 percent in 1987 to 45 percent in 1994 (Goldberg et al., 2010; p. 1734)

The Indian government relaxed FERA and increased foreign equity upto 51 percent on an automatic route in 35 priority sectors, such as machinery, the chemical industry, the pharmaceutical industry, auto components and automobiles. The background of these changes was that the relevant industries needed to improve technology and financing for Indian economic growth (Palit, 2009). In 2000, automatic approval was allowed in most industries, except for a few important sectors, and the Special Economic Zone was also set up by providing tax incentives and establishing infrastructure.

Narendra Modi, who was inaugurated as Prime Minister in 2014, started initiating the ‘Make in India’ campaign to develop India’s manufacturing sector. Therefore, the Indian government has tried to improve infrastructure and institutions to attract FDI, including tax reforms and simplification of administration procedures. By doing so, India was ranked at 100 on ‘Ease of Doing Business’ published by the World Bank in 2016, which was 130 in 2015. The Indian government relaxed regulations on FDI in prohibited sectors such as single brand retail, defense and mining.

![Figure 1] FDI inflows from 1970 to 2016

Figure 1 shows the evolution of FDI inflows into India from 1970 to 2016. Looking at the
chart, it is clear that FDI inflows started significantly increasing after economic reforms in 1991 and reached the highest peak in 2008. The global financial crisis in 2008 resulted in a global economic slowdown, leading to discouraging FDI. India’s FDI started increasing from 2013. In 2016, FDI inflows were 44.5 billion US dollars according to the United Nations Conference on Trade and Development (UNCTAD), increasing by 187 percent from 1990 to 2016.

However, the most recent data shows that the growth rate of India’s FDI inflows is the lowest in five years. According to the data published by the Department of Industrial Policy and Promotion\(^7\), FDI inflows in FY2018 were 44.85 billion US dollars, increasing by only 3.1% from 43.47 billion US dollars in FY2017\(^8\).

3. FDI and Export of India’s Textile and Apparel Industry

The manufacturing sector is important to the Indian economy for employment generation and its significant share in GDP. With the ‘Make in India’ initiative in 2014, India is expected to evolve as a manufacturing hub in the world to become the fifth largest manufacturing country. According to the Global Manufacturing Competitiveness Index, India was ranked at eleventh in 2016 and the ranking is projected to increase to fifth in 2020\(^9\). To achieve this goal, the Indian government emphasizes the importance of FDI. Hence, we analyze the role of FDI in export performance in the textile and apparel industry, and automobile industries.

The textile and apparel industry plays a major role in the Indian economy with its contribution of 15% in exports, 14% of industrial production and efficient employment generation (India Brand Equity Foundation, 2018b). India has a comparative advantage in the textile and apparel industry with abundant raw materials of cotton, silk, jute, man-made fibers and yarn, with production facilities covering each stage from raw materials to final products (Vanishree, 2011). Therefore, India has cost efficiency in textile and apparel manufacturing with low labor costs (FICCI, 2017). In spite of that competitiveness, FDI inflows in this sector have not been impressive, due to late liberalization and high government protection.

The main feature of India’s textile and apparel industry is that there are many small and

\(^7\) http://dipp.nic.in/publication/sia-statistics
\(^8\) India’s fiscal year starts from April and ends March. Hence, FY2018 means from April in 2017 to March 2018. As data published by the Indian government is based on the fiscal year, data might be different from other institutions. In the case of FDI data, the Indian government provides only from FY2000. To show longer period, we need to employ different type of data than the Indian government.
micro-sized firms; hence this industry has been highly protected by the government policies including restriction of FDI and reservation of small sized firms. FDI was only allowed in this sector in the mid 1990s. India’s textile and apparel industry allows 100 percent FDI under the automatic route. In addition, the reservation for small sized firms also reduced from 873 items to 79 items in 2017, implying that foreign firms can enter production in those sectors as well. Recently, the Indian government allowed FDI in multi-brand retail up to 51%; previously only single brand retail FDI was allowed up to 100%.

Table 1 above shows the FDI inflows and exports in the textile and apparel sector from FY2007 to FY2016. Export volume increased at a CAGR of 7 percent during the period from FY2007 to FY2016, while FDI inflows grew at a CAGR of 17 percent for the same period. However, the share of textile and apparel industry in total FDI inflows into India was less than 1 percent from 2000 to 2014. The low level of FDI in this sector is due to poor infrastructure and lack of trade agreement (Ministry of Textile, 2016).

However, US International Trade Commission (2011) showed that late liberalization of FDI in the textile and apparel industry hindered FDI inflows in India. This again led to sluggish export performance in India’s textile and apparel industry. While India was restrictive in attracting FDI in this sector, foreign companies started business in other developing countries, China and Southeast Asian countries. Moreover, India’s export performance in the textile and apparel industry is not impressive in spite of its advantages. Recent trade data by World Trade
Organization (2017) shows that China is the top exporter in textile and apparel in the world and Southeast Asian countries, such as Vietnam and Indonesia, are main competitors against India in the global exporting market. In the global market, India’s share of export in textile and apparel is around 5 percent, compared to China with a share of 40 percent.

The low export competitiveness of India’s textile and apparel industry is attributed to low value added export basket and lack of modern production facilities (Manoj and Muraleedharan, 2016). To improve production facilities and infrastructure, India needs a large amount of investment, in which FDI is required.

4. FDI and Export of India’s Automobile Industry

The contribution of the automobile industry in India’s GDP is over 7.1% and the share in manufacturing GDP is around 22% (India Brand Equity Foundation, 2018a). Due to its forward and backward linkages, the automobile industry is important in the development of manufacturing. Therefore, many countries strategically develop the automobile sector for their industrial growth.

According to the International Organization for Motor Vehicle Manufacturer (OICA), India was the fourth largest producer of passenger and commercial vehicles in 2017 globally and was the tenth largest producer in 2007\(^\text{10}\). India now produces more vehicles than Korea and USA. A reason behind India’s impressive progress in automobile production is FDI.

Unlike the textile and apparel industry, the automobile industry started allowing FDI from the early 1980s. India began limited liberalization and deregulation in the early 1980s for economic growth. The Indian public automobile manufacturer, the Maruti Udyog, created a joint venture, Maruti Suzuki, with the Japanese company, Suzuki, in 1982. Maruti Suzuki focused on the small sized car segment starting with production of small sized cars. In 1985, Maruti Suzuki first exported passenger cars to Eastern European countries\(^\text{11}\).

The New Industrial Policy in 1991 encouraged deregulation on FDI. In the case of the automobile sector, all vehicle segments except for passenger cars were allowed to attract FDI up to 51 percent in 1991; FDI in passenger cars was allowed in 1993. With deregulation, India has been attractive to foreign investors due to its large population for domestic consumption and geographical location for the export platform. In the Auto Policy 2002, 100 percent FDI in India’s automobile industry was allowed in order to increase India’s exports. Likewise, the

\(^{10}\) http://www.oica.net/category/production-statistics/2017-statistics/
\(^{11}\) https://www.business-standard.com/company/maruti-suzuki-5496/information/company-history
Indian government understood the role of FDI in the export of automobiles. In FY2017, FDI inflows into India’s automobile industry was 1,609.32 million US dollars, increasing from 260.72 million US dollars in FY2007. The automobile sector is one of the highest FDI attracting industries in India and its share in India’s GDP is around 7 percent. The share of the automobile industry in India’s FDI from 2000 to 2015 was 5.2 percent\(^{12}\). In early 2000, when many foreign companies entered the Indian market, the share reached 8 percent.

<table>
<thead>
<tr>
<th>Year</th>
<th>FDI</th>
<th>Export</th>
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<tbody>
<tr>
<td>FY2007</td>
<td>260.72</td>
<td>126414.05</td>
</tr>
<tr>
<td>FY2008</td>
<td>656.1</td>
<td>163132.18</td>
</tr>
<tr>
<td>FY2009</td>
<td>1150.03</td>
<td>185295.36</td>
</tr>
<tr>
<td>FY2010</td>
<td>1236.29</td>
<td>178751.43</td>
</tr>
<tr>
<td>FY2011</td>
<td>1299.41</td>
<td>249818.55</td>
</tr>
<tr>
<td>FY2012</td>
<td>922.99</td>
<td>305963.92</td>
</tr>
<tr>
<td>FY2013</td>
<td>1537.28</td>
<td>300400.58</td>
</tr>
<tr>
<td>FY2014</td>
<td>1517.28</td>
<td>314405.3</td>
</tr>
<tr>
<td>FY2015</td>
<td>2725.64</td>
<td>310338.48</td>
</tr>
<tr>
<td>FY2016</td>
<td>2526.82</td>
<td>26290.13</td>
</tr>
<tr>
<td>FY2017</td>
<td>1609.32</td>
<td>275841.71</td>
</tr>
</tbody>
</table>

Source: Department of Industrial Policy and Promotion, Ministry of Commerce and Industry (FDI), Reserve Bank of India (Export)

India’s export amount of automobiles doubled to 275.8 billion US dollars in FY2017 from 126.4 billion US dollars in FY2007, while export volume of automobile increased to 4,040,172 in FY2018 from 2,898,907 in FY2013 by 40 percent. The share of export in production of automobiles increased to 15.2 percent in FY2016 from 12.9 percent in FY2011. This implies that India’s automobile industry has competitiveness in the global market (Export-Import Bank of India, 2017). Hence, India’s share of global automobile production is around 5 percent.

Recently, India started production of Volvo luxury buses and exporting them to Europe, which is Asia’s first such export\(^{13}\). New investment by foreign automobile companies encouraged the diversification of production and exporting goods. As shown in the study of Rajalakshmi and Ramachandra (2011), FDI has a positive impact in the development of

\(^{12}\) http://dipp.nic.in/sites/default/files/Chapter6.2_v_0.pdf

\(^{13}\) https://www.business-standard.com/article/companies/foreign-automakers-make-india-their-export-hub-116032800696_1.html
automobile industry and export performance.

5. Conclusion

In the developing countries, FDI has a crucial role for economic growth as foreign companies bring advanced technology and managerial practice as well as competition, which in turn improves productivity. Moreover, FDI also encourages exports as foreign companies can easily access to the global market. Therefore, there are positive impacts of FDI on export performance in the developing countries.

As the Indian government launched ‘Make in India’ initiative in 2014, the need of FDI is increasing for capital and technology. In this context, India is in a transition toward being a favorable FDI destination with deregulation, liberalization and administrative simplification.

As can be seen from the case of the textile and apparel industry, and the automobile industry, FDI inflows into India has increased after the reforms, along with exports. However, in the case of the automobile industry, FDI has increased even since the early 1980s when India restricted in liberalization. On the other hand, the textile and apparel industry was highly protected by the government, which in turn led to there being many small sized firms in this sector. Even though India’s textile and apparel industry has competitiveness and comparative advantage in the global market, this sector could not enjoy those benefits due to limited role of FDI.

This study has limitations. It is recommended that further studies conduct empirical analysis with a longer study period, if possible. In addition, the analysis of the service sector that India attracts the highest amount of FDI and its export performance is also impressive is also meaningful for policy suggestions.

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