Nagesh Kumar. 1995. Industrialization, Liberalization and Two way Flows of Foreign Direct Investment: The case of India. The United Nations University – INTECH Discussion Paper no. 9504 (June). UNU/INTECH: Maastrich.

Generalities

The pattern of an economy's inward and outward FDI changes with the structural transformation of the economy, because it affects the competitive advantage of foreign investors vis-à-vis domestic investors (ownership advantage), the relative competitiveness of location bound resources and capabilities (locational advantage), and the propensity of foreign firms to utilise the ownership advantage internally rather than through the market (internalisation incentive). With the development of the economy, the configuration of these advantages change, which gets reflected in the FDI position of the economy.

An economy's FDI position is expected to change through a sequence of stages according to (Dunning's) investment development path (IDP).

The first, *factor driven*, stage is characterised by poor infrastructure and technological and productive capacities. All FDI is inward – FDI (in) – and focused in extractive (mining) and other primary resource activities (plantations, etc).

The second, *investment driven,* stage the development of the local market and infrastructure and the creation of locational advantages through protection and ISI brings in import substitution manufacturing, and domestic firms develop some ownership advantages and technological capacities that can lead to outward FDI in this and the next stage. FDI (out) is expected to be related to trading and market seeking, and some productive activities in economies that are located on a lower IDP stage. At this stage, FDI (in) should be moving to higher levels of sophistication as its ownership advantages in standardised products and industries is eroded by the development of domestic firms.

In the third, *innovation driven,* stage both inward and outward FDI move upwards towards more sophisticated levels of activity. This is because of the strengthening of domestic firms and the enlargement of domestic markets and increase in income. The competitive advantages thus developed will allow the economy to move towards a more sophisticated export market, as well as more sophisticated FDI (out).

In the final stage, *wealth driven¸* the accumulation of acquired assets by domestic firms reaches a level where FDI (out) and FDI (in) are evenly balanced.

> *Note: This account of the IDP is very similar to the (in) famous stages of economic development.*

India

In India, industrialisation was undertaken under successive stages of import-substitution, which helped to shape and accelerate capitalist industrial accumulation and develop productive and competitive advantages for domestic capital. ISI was implemented through a series of means: protection; a combination of planning/selectivity and licensing for resource management; heavy public investment in infrastructures, education and training, labs, strategic sectors and areas considered too risky or costly for private capital; state nurtured institutional development (ex., of the financial system); and mobilisation of FDI to attract entrepreneurship, capital (to complement India's low savings rate and provide the much needed, and scarce, foreign currency), skills and technology.

FDI (in) was attracted, initially, by India's resources (plantations, etc.) and later by its large, protected domestic market and, as they developed, by India advantages with respect to human capital and technological capabilities. FDI was required to operate in areas, and brings assets not available to domestic firms because of the capital, management and skill demands. The Indian government also demanded FDI to transfer technology and organise itself into joint ventures with Indian established companies. The government put in place policies that favoured licensing (by increasing internalisation costs). Also, the government attempted to promote export oriented FDI (in) by creating EPZs.

FDI (out) developed in two different paths. In LDCs located at a lower stage in IDP, Indian companies had ownership advantages; benefited from locational advantages due to presence of markets, incentives and ISI; and had internalisation incentives associated with skills and management and incentives towards FDI. Hence, productive capacities were created in many LDCs. In countries were Indian productive capacity could not hold ownership advantages, FDI (out) from India was in trading and services, particularly as subsidiaries of Indian companies to guarantee markets: these subsidiaries represented the parent company, acquired information and knowledge, and established the presence of the parent firm in the market. In a world where non-price factors are increasingly more important in competitive games, market presence is crucial for market penetration. India then acquired ownership advantages in trading and services (such as restaurants) in industrialised economies.

There are five interesting points that are raised by the discussion in the article but that are not properly answered (if an answer is at all attempted):

- India's FDI (out) grew significantly faster than exports and significantly slower than FDI (in). Therefore, India had systematic balance of payments crisis. The question is why have exports failed so tragically, particularly given the fact that India's ownership and competitive advantages in many areas were very substantially developed?
- India failed to attract EO FDI (in), and even the ambitious EPZ programme and trade and investment liberalisation did not help. Why has India not used more aggressively its own capacities (skills, knowledge, large markets, etc) to bargain with MNE and create more exporting capacities?
- The Indian government's attitude towards FDI (in) was shaped by two major problems: (i) on one hand, the need to create entrepreneurship and technological capacities at home; and (ii) on the other hand, the problems with the current account balance. The government restricted FDI when servicing it become a large current account burden; then liberalised FDI when restricting created productive capacity problems; then liberalised further when new current account problems emerged.
- It seems that in India there was a trade-off between FDI (out) and exports – it does not mean that the export failure is largely attributable to FDI (out), but simply that there seems to be a trade-off. This trade-of may be more pronounced when instead of "exports", FDI (out) is compared with net foreign exchange gains (in the short and medium term, FDI (out) is a deduction in the country's foreign reserves).
- This brings about the fifth and final problem: nowhere in the Indian industrialisation strategy the issue of current account balance and foreign exchange financing is endogenously addressed. The whole issue of forex seems to be dealt with purely on the account of FDI and trade policy, without specifically trying to re-directed India's very large competitive productive capacity to export more.