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FDI inflows: Who is investing in India and in what sectors?

Foreign direct investment (FDI) inflows into India have been steadily rising in importance since the early 2000s until the global financial crisis.

In absolute terms and as a share of GDP, net FDI inflows peaked in 2008, representing around 3% of the share in world FDI flows (figure 1).

While the global financial crisis initially contributed to a slowdown in FDI inflows, the rather sharp downward trend and the consequent sluggish recovery of FDI that can be observed in the post global financial crisis phase has primarily been a result of a host of domestic factors.

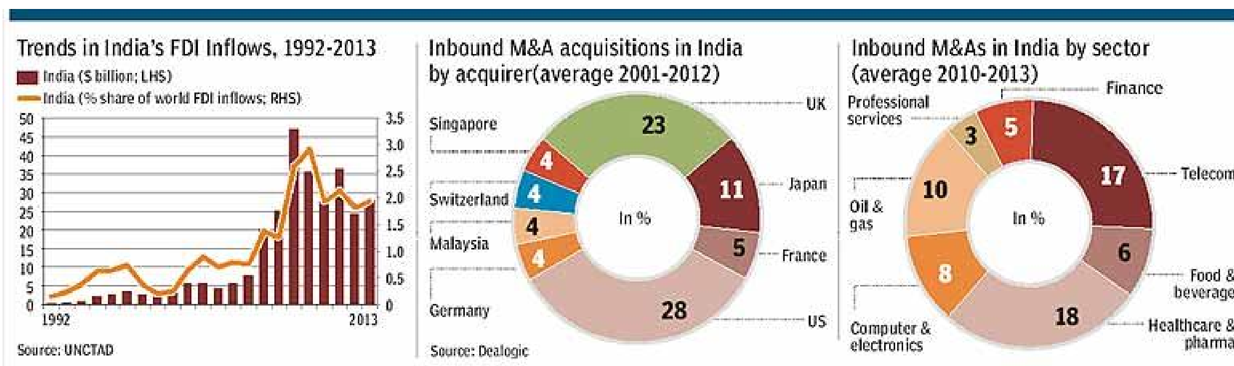
Policy challenges on multiple fronts, including issues of governance, inadequate structural reforms, tax and political uncertainties, all contributed to the lacklustre performance of FDI in India.

While there are signs of stabilisation in net FDI inflows, India still has a long way to go to return to the pre- global financial crisis peak. In this light, it is not surprising that the Modi government has reiterated that the country's FDI regime is highly open and conducive for attracting such flows of foreign capital.

Until 2012, about 40% of FDI inflows used to come from Mauritius, just under 10% from Singapore, and another 5% from the Netherlands.

These tax havens and offshore financial centres (OFCs) together made up just over half of all FDI inflows to India. In 2013, however, the composition changed, with Singapore's share rising to 25% (boosted by the double taxation avoidance agreement the two countries have signed which has incorporated a Limitation of Benefit—LoB—provision), Mauritius with about 20% and the Netherlands at around 5%.

While Singapore and Mauritius have swapped places as top investors in India, still about 50% originates from these offshore financial centres. Clearly, these are not the original sources of external financing with the offshore financial centres responsible for a degree of round-tripping of funds from India and transshipping of funds from third countries. Accordingly, an analysis based on such data can be quite misleading when trying to understand economic linkages between countries.



If one wants to get a sense of the original source of these FDI flows, i.e. who is actually doing the investment in India and to understand the de facto real linkages at the bilateral level, mergers and acquisitions (M&A) data could offer a better, albeit partial, picture for that purpose. This is so as M&A data are based on actual ownership of the company as opposed to flow of funds. The M&A data only include direct investment that is foreign in nature and not merely round-tripping back to India from domestic sources.

However, one has to be careful in comparing M&A versus FDI data. First, not all FDI are M&As as they could be greenfield investments as well. Second, M&A transactions do not necessarily result in international capital flows across borders (for example, swapping of shares). Third, M&A data refer to the total deal value as at the date of completion though the deal value may be paid out over a number of years. Fourth, unlike FDI data, M&A data do not include retained earnings (which is a significant share of global FDI flows).

A comparison of the available FDI data to M&A data for India reveals an entirely different picture (figure 2). Countries like the US and the UK together make up 50% of M&A acquisitions into India, and Japan is responsible for another 10%. This triad is effectively responsible for three-fifths of FDI inflows into India (of the M&A variety at least). This provides us a more useful geographic breakdown of who is actually doing the investments in India.

A sectoral analysis of FDI inflows suggests that, on average, between 2000 and 2012, more than 35% of FDI inflows have gone into services, telecom and construction sector, with pharmaceuticals, chemicals and computer sector each receiving about 5% of the country's total FDI inflows over the corresponding period. However, M&A data at the sectoral level for the same time span suggests telecom and pharmaceuticals (and healthcare) have attracted over one-third of the foreign M&A acquisitions in India. Of late, pharmaceuticals has attracted a greater share of M&As, with the sector taking about 20% of inbound M&A acquisitions between 2010 and 2013 (figure 3).

What does the foregoing discussion imply for policy? Obviously, first and foremost there is a need for better appreciation of the actual sources and destinations of FDI to and from India as well as the sectoral composition of FDI flows. In fact, while not discussed here, as Indian companies invest overseas more aggressively, better quality data on gross inflows and outflows at country and sectoral levels are needed.

Much more attention is also needed with regard to FDI quality at a more disaggregated level (i.e. new FDI versus retained earnings and greenfield versus M&A). While it is important for India to attract FDI, it is pertinent to ask the question whether a policy to attract FDI should be careful in distinguishing between the kind of FDI it wants to attract. All FDI are not the same and are not attracted by the same factors. The prime objective must be to align FDI with national development objectives, consistent with being an open economy.

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