Foreign Direct Investment (FDI): Implications for the economy and markets

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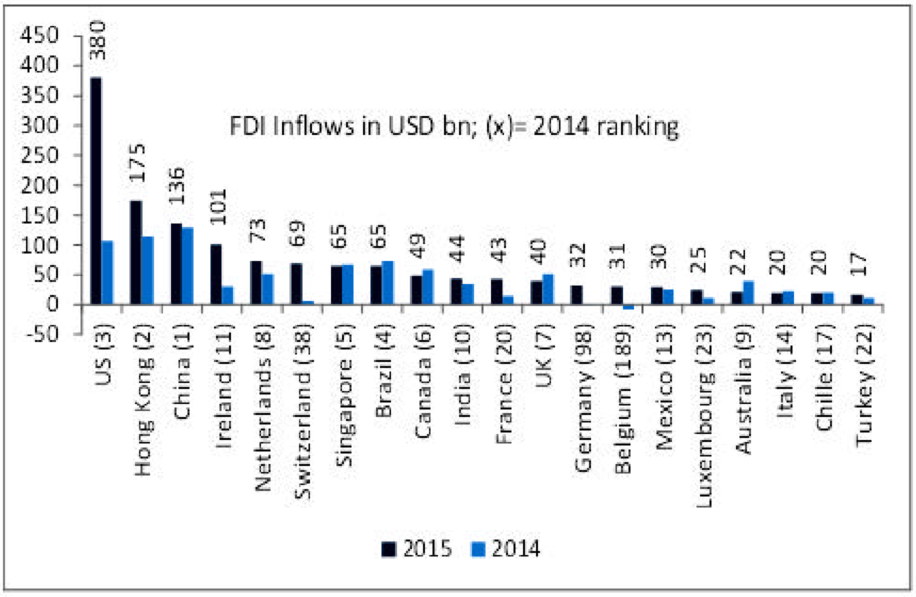
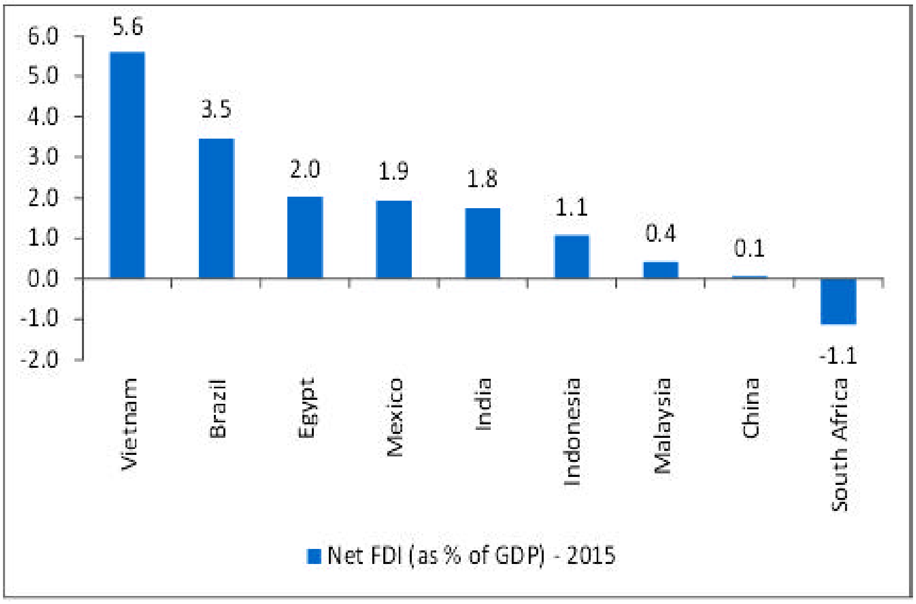
Historically, Indian markets have been vulnerable to the global liquidity and sentiments due to over-dependence on FII flows. Whether it was the Lehman crisis of 2008 or Euro crisis in 2011-12 or Taper tantrum of 2013, these swings in FII flows impacted not only the equity, bond and the currency market but had larger repercussions on the real economy as well. While increasing domestic flows (both retail and institutions like PFs) have the potential to cushion the impact of FII flows, a heartening feature is India's emergence as a favourite FDI destination.

FDI inflows have risen rapidly in India from US$ 31 billion in FY14 to US$ 45 billion in FY16 helped by macro and political stability, government's efforts to ease foreign investment norms and to a certain extent also by China losing its attractiveness in terms of investment destination. The increase in FDI has provided a necessary support to external account balance in times of volatile FII inflows. It also helps to partly bridge the gap of muted private sector capital investment apart from benefits of job creation, technological innovation and productivity enhancement. Thus far, the benefit of increased FDI influx has largely accrued to the services sector. The much needed FDI in manufacturing sector and infrastructure activities is yet to benefit from easing FDI norms.

Last month, the Indian government announced a slew of liberalization in FDI norms across various sectors including defence, aviation, broadcasting, trading etc. This is yet another set of announcements in a series of FDI reforms carried out by current government since it assumed office in May 2014.

Government's effort to liberalize FDI in India, coupled with restoration on macro stability since 2014 has led to surge in FDI inflows in India. India received the highest ever FDI inflows in FY15-16 at US$ 45bn, amounting to 2.1% of GDP and 7.3% of GCF. Since 2014, India has featured among the top ten countries in terms of FDI inflows globally and the fourth in developing Asia (source UNCTAD 2016 report). That said, in terms of net FDI, India is still far from the top of the league tables in terms of net FDI inflows/GDP. The latest relaxation in FDI norms will hopefully attract more FDI and improve its ranking.





Easing of FDI norms by government has helped

Ever since the current NDA government has assumed office in May 2014, it has relaxed the FDI norms in agriculture and food processing, financials and other services, aviation, information and broadcasting, construction, defence, e-commerce, wholesale and retail trading, pharmaceuticals and railways. Increasing the FDI cap (such as in insurance and pension), relaxation the terms and conditions for investment (such as in defence and single brand retail trading), easier exit norms (such as in constructions), greater definitional clarity and bringing more and more investment under automatic route (vs. the government approval route) has been some of the easing measures carried out by the government.

Out of the above listed sectors that were liberalized, services were the biggest beneficiary, as FDI inflow surged by 148% to US$ 8.1bn in FY16. Other sectors that benefitted were civil aviation, construction, information and broadcasting. FDI in construction activities (US$ 4.7bn in FY16, 156% higher than FY15) could partly fill for lack of private capex appetite.

Meanwhile, railways, pension and defence are yet to benefit from the relaxation in their FDI norms. In case of pharmaceuticals, FDI inflow has slowed in FY16 after seeing large number of big-ticket deals being carried out in FY14 and FY15. With the recent relaxations, the M&A deals in pharmaceuticals could pick-up again.

	USD mn			% Share		
	FY14	FY15	FY16	FY14	FY15	FY16
Agriculture and allied activities	**4,940**	**1,214**	**945**	**20.3**	**3.9**	**2.4**
Infrastructure incl Energy	**5,105**	**7,194**	**7,871**	**21.0**	**23.3**	**19.7**
Construction	1,965	1,825	4,666	8.1	5.9	11.7
Energy	1,596	2,344	1,807	6.6	7.6	4.5
Railways	237	130	74	1.0	0.4	0.2
Telecommunications	1,307	2,895	1,324	5.4	9.4	3.3
Manufacturing	**7,321**	**10,784**	**8,012**	**30.1**	**34.9**	**20.0**
Automobile	1,517	2,570	2,682	6.2	8.3	6.7
Chemicals ex fertilizers	937	716	1,603	3.9	2.3	4.0
Machinery & Equipments	1,460	3,305	719	6.0	10.7	1.8
Materials	453	447	599	1.9	1.4	1.5
Metallurgical Industries	568	472	344	2.3	1.5	0.9
Pharma	1,453	1,678	893	6.0	5.4	2.2
Textiles	199	163	265	0.8	0.5	0.7

Other	734	1,432	908	3.0	4.6	2.3
Mining	**13**	**659**	**546**	**0.1**	**2.1**	**1.4**
Services	**6,920**	**11,080**	**22,627**	**28.5**	**35.8**	**56.6**
Services (DIPP Classification)	2,225	3,253	8,080	9.2	10.5	20.2
Computer Software	1,126	2,200	6,000	4.6	7.1	15.0
Consultancy	286	428	547	1.2	1.4	1.4
Education	262	143	166	1.1	0.5	0.4
Healthcare	685	663	647	2.8	2.1	1.6
Hotel & Tourism	486	799	1,311	2.0	2.6	3.3
Information & Broadcasting	429	257	1,008	1.8	0.8	2.5
Trading	1,355	2,930	4,074	5.6	9.5	10.2
Transport	67	407	793	0.3	1.3	2.0
Total	24,298	30,930	40,001	100.0	100.0	100.0

Incremental FDI has largely been directed towards the service sector

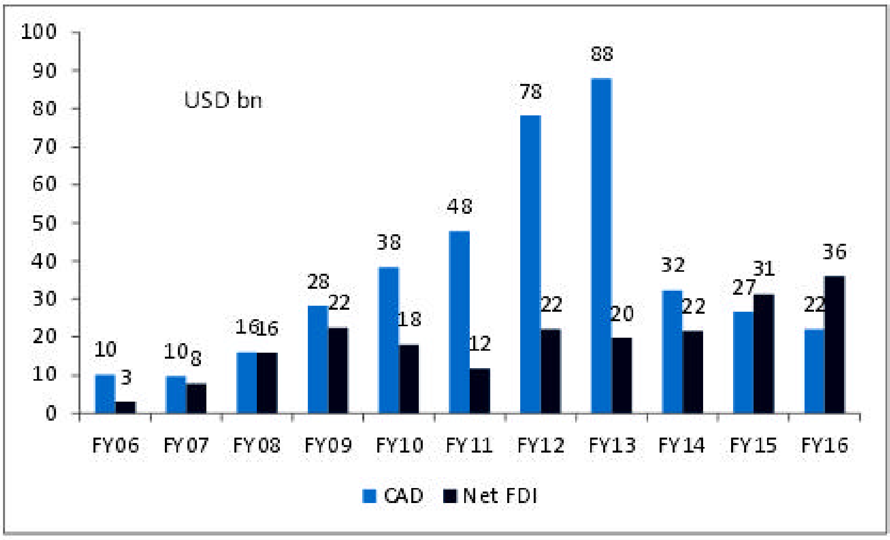
Apart from the above mentioned sectors, surge in e-commerce and start-ups in India has helped software to be the top recipient of FDI in FY16 (US$ 6bn in FY16, 173% higher from FY15). On the other hand, manufacturing activities still suffer from lack of adequate and desired FDI interest and share of manufacturing in total FDI inflow fell from 35% in FY15 to 20% in FY16. However, we do see an early signs of some of the fresh foreign investments shifting from previous practice of creating assembling units to establishing full-fledged manufacturing and R&D facilities in India (particularly in the auto and electronics sector).

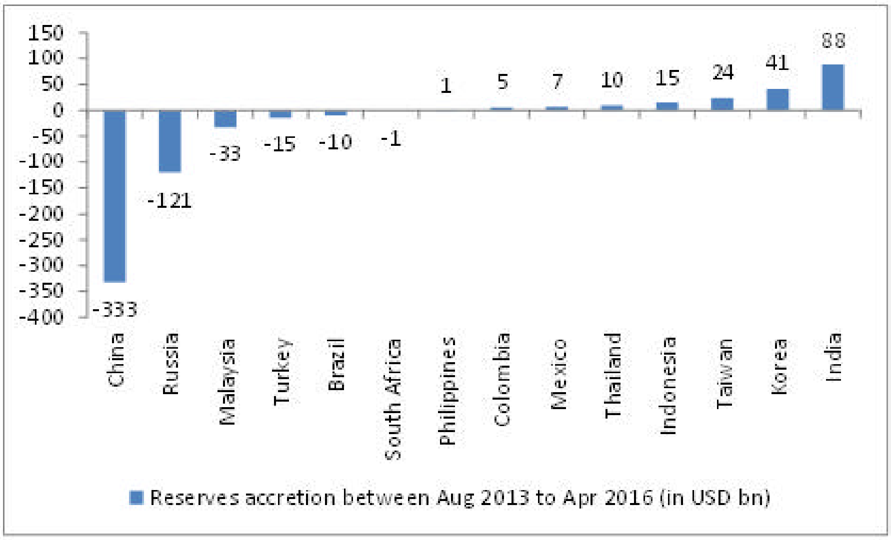
FDI led capex to bridge the gap from muted private investment:

Since last two years, private sector capital investment in India has been muted. While insufficient capacity utilization has been one of the reasons, Indian corporates also grapple with the issues of unviable projects (due to delayed project clearances during the previous government and sudden collapse in global commodity prices) leading to mounting debt in their balance sheets. At the same time, Indian banks are dealing with rising stressed assets which inhibit their ability to lend aggressively. Both government and the RBI have been working to enhance the internal capital availability by focussing on cleaning of banks' balance sheets, implementing various restructuring plans (such as UDAY for power distribution companies, business restructuring, right-sizing debt maturity profile, bringing in new promoters, improved governance through an independent Bank Board Bureau, policy support to stressed industrial sectors, capital infusion by government) and, increasing the government capital spending. At such a time, till internal issues gets resolved, increased influx of FDI serves as an important avenue to bridge the private capex gap.

FDI inflows keeps India well positioned on the external balance front

As FDI is one of the most stable forms of foreign capital inflows, it keeps India well positioned on the external balance front. In fact since last two years, net FDI alone has been sufficient to fund India's current account deficit (also attributed to reduction of CAD), take India's balance of payment into surplus and restore the stability of Indian rupee. While many emerging markets have seen the depletion in their foreign currency reserves, India has been an outlier to see 88bn of reserves addition since August 2013.





To sum up, rising FDI inflows have significant positive implications for the economy. On one hand, it provides a sustainable form of external financing to investment activity, ensures balance of payment stability, while on the real economy front, it boosts investment led growth, helps job creation (in case of greenfield projects) and enhances productivity of the country. With government policy being in favour of attracting FDI, this inflow momentum is likely to continue.