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Impact of Foreign Direct Investment (FDI), Foreign Portfolio Investment(FPI) and Profit Repatriation on Developing Economies : An in Depth Study

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ABSTRACT

Both FDI and FPI are extremely important sources of investment for developing economies like India. Amongst the two FPI is more volatile which is why most developing countries encourage FDI. The money coming in via FDI adds to the increasing amount of capital expenditure that takes place in the economy. The domestic investment is inadequate for the economy to reach a developed status, which is the reason why FDI is encouraged. To increase this component the government has tried inputting regulations and policy measures in place as well as improving on the infrastructure.

Key Words: FDI, FPI, Profit Repatriation, developing countries, macroeconomic indicators, host country, interest rate, volatility, capital.

Research Question: What is the Influence of Profit Repatriation on various aspects of a Developing Economy? How does this affect Macroeconomic Indicators? Is it influenced by the political equations that the Country has with other Economies of the world? How far do Eco-geo-socio relationships impact FDI and FPI in an economy? These and such similar questions would be attempted to be answered in the course of this paper

1. Introduction

For developing economies that require investment to help in increasing the GDP of an economy. It becomes imperative to garner this resource from both domestic and foreign sources. It is the lack of domestic savings that inhibits the investment of a developing economy, further impacting the growth of GDP. It is a proven fact that the higher the rate of investment, both public and private, the greater the GDP of that economy. If there is inadequate domestic savings (from the

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government, from the private sectors, and households), it becomes necessary to try and attract investment from other countries.

FDI is considered a major source of non-debt financial resources for economic development. Since the 1990s, when the Indian economy liberalized and globalized, foreign capital has continuously grown and has contributed toward technology transfer, development of strategic sectors, greater innovation, competition, and employment creation, among other benefits. Therefore, it is the intent and objective of developing countries, like India, to attract and promote FDI in order to supplement domestic capital, technology, and skills for accelerated economic growth and development.

FDI versus FPI indicates that the former has a lasting interest in an enterprise while the latter is primarily interested in the country's stock exchange.

To consolidate the FDI of an economy, changes need to be made on a regular basis to capture and keep pace with the other evolving policies of various countries of the world.

Since globalization, the world has become one, and any factor that affects any other part of the world would automatically impact all other countries. The various wars and strikes that are presently in force (the Russian-Ukraine crisis, the Hamas-Israel conflict, and South Sea issues) have impacted the world adversely. This indicates that there are political connotations to economic decisions.

The pattern of capital inflows in developed and developing economies is different due to dissimilar economic and political structures. In the case of developing countries, portfolio flows are considered extremely important in reducing the gap between savings and investment and providing for an exchange that could bridge the current account gap. Investors of developed countries invest in portfolios of different countries so that they can diversify the risk and earn higher returns. For portfolio investors, they largely go for short-term investments so that they can reap the benefits of good economic conditions (boom periods) and withdraw their investments during periods of recession.

Developed economies require foreign capital inflows to sustain their development process, whereas developing economies require foreign investment to stimulate economic growth.

2. Definition

It is important to understand the difference between FDI and FPI, as they both have different impacts on the growth of an economy. This form of investment impacts a developed and a developing nation in different ways. The reason that both these forms of investment are

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encouraged is because domestic investment is not sufficient to achieve the desired level of growth. For growth to occur in an economy, investment is an extremely important factor. Largely this investment comes from savings. These savings can be domestic and foreign. When the domestic savings are inadequate, foreign savings are tapped. These are in the form of FDI and FPI.

FDI is an investment made by a foreign company or individuals with the main intention of establishing a long-term business interest. In this case the investor acquires a controlling interest in a foreign company by purchasing at least 10% of the company's shares. This in turn gives the investor a say in the management of the company, and the aim is to establish a long-term business interest in the foreign country.

FDI can take several forms:-

- Mergers and Acquisitions; This involves the purchase of an existing company merging with a local company to establish a new company.
- Greenfield investments; This involves the establishment of a new company in a foreign country.
- Joint ventures; This involves partnering with a local company to establish a new company.

FDI has several advantages that include:-

- Creating jobs
- Transference of technology and knowhow
- Boosting the economy of the host country
- Providing a stable source of investment capital
- Enhancing the competitive advantage of local companies by introducing new business practices and technology
- Allows investors to access local market due to enhanced investments in their firms

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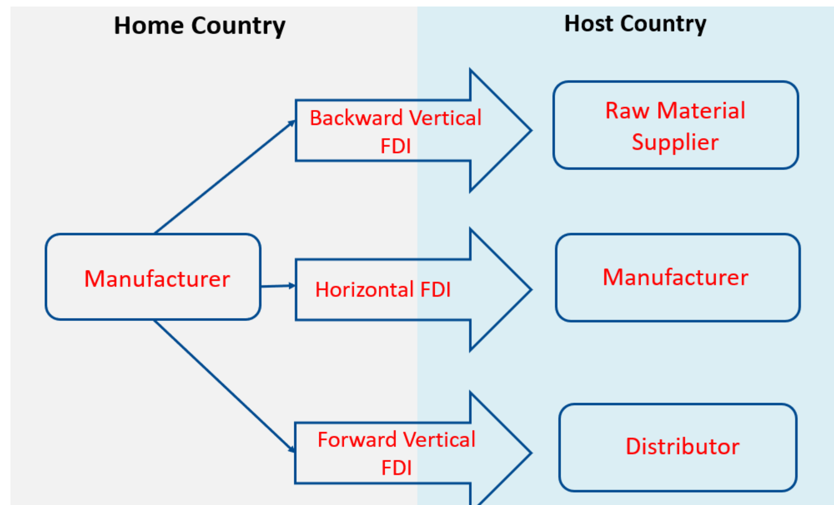
Figure 1: FDI



Source: Yadnya Investment Academy

FPI: This is an investment that is made by foreign investors in foreign securities such as stocks, bonds, and other financial assets. FPI does not involve the acquisition of a controlling interest in the company. It is a short-term investment with investors buying and selling securities based on short-term market trends.

These can take several forms like;

- Equity investment
- Debt investment; These involve buying bonds issued by foreign governments or companies.
- Mutual Funds
- Exchange traded funds (ETF)
- Real estate investment trust

Advantages of FPI are:

- Provision of diversification of investment portfolios
- Reducing risk exposure

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- Allows investor to participate in the growth of foreign economies without the need for long term commitment
- Provision of liquidity as investors can buy and sell securities quickly

The disadvantages of FPI are that they are subject to:

- Volatility of financial markets
- Volatility of the foreign exchange market
- Fluctuations in interest rates and other macroeconomic factors
- They have no say in the management of the companies
- FPI does not promote economic growth or job creation or technology transfer in the host country.

Figure 2: FPI

Source : Wall Street Mojo

Repatriation of Profit

This signifies the ability of a firm to send foreign-earned profits or financial assets back to the firm's home country, normally in currencies like the US dollar, Euro, and pound, after meeting the host nation's tax obligation.

In the case of repatriation of profit, the effect of taxes on dividend decisions can impact the extent of repatriation. Depending on the laws of the host country, it is possible that the managers

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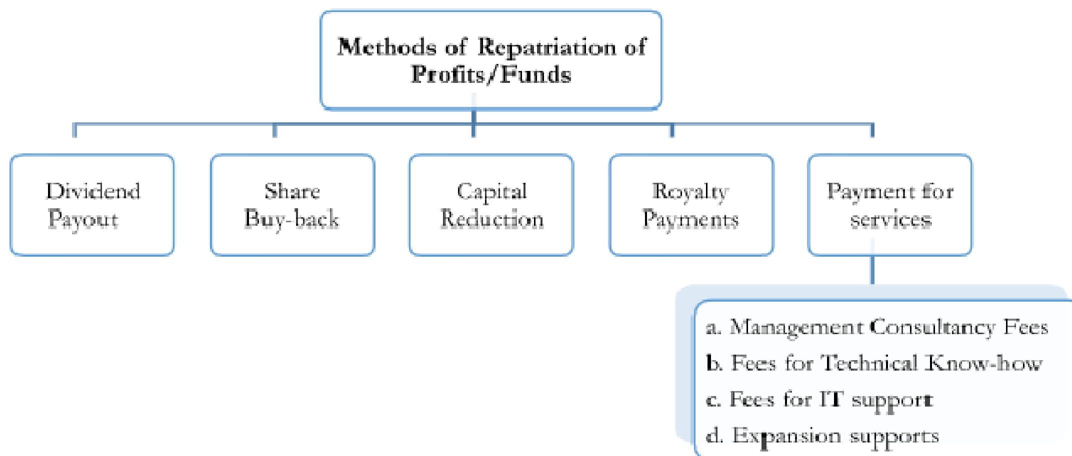
prefer to reinvest in the host country rather than repatriate the profits to its shareholders in the foreign country. Firms that invest are normally MNCs, and the motivation that they have is primarily:

- Access to natural resources
- Market seeking
- Efficiency seeking
- Strategic asset seeking

Besides the above, developing countries offer incentive schemes like tax holidays, financial subsidies, etc., to encourage FDIs to invest in their economy.

In India, different states have taken it upon themselves to provide the right platform to encourage foreign investors to enter and set up factories in their states. The incentives could be, for example, the provision of land and extremely nominal rates or a very long lease. It could also be in the form of an uninterrupted power supply and adequate infrastructure in the form of roads, etc., to help the industry to grow.

Figure 3: Methods of Repatriation of Profits



Source: Companies Next

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3. Impact of FDI, FPI and Repatriation of Profits on the host country:

3.1 On Macroeconomic Indicators in a Developing Economy

To attain higher GDP is one of the main reasons why a developing country wants and needs foreign investment. There exists a significant relationship between macroeconomic factors and foreign portfolio investment volatility. FPI is the result of liberalization that occurred in most developing economies in the 1980s but was seriously implemented in India in the 1990s. FPI and FDI are two arms of investment that foreign companies invest in developing economies. FPI is more volatile than FDI, and most developing economies would prefer the latter as it would enhance the economic development of an economy.

FPI enters into an economy if the interest rate prevalent in the host country is higher than that which is earned in their own country. The risk factor involved in FPI is immense, as the international investor's intention is to invest for short-term benefits, and they withdraw their investment when conditions are uncertain. Besides the interest rate that is earned, it is also the exchange rate and, more importantly, the real interest rate that impact the extent of investment in an economy. This essentially means that inflation levels impact the volatility in FPI.

FDI, on the other hand, is likely to decrease the volatility that is experienced in the case of FPI. The moment the foreign investor has taken a decision to increase FDI, it indicates the confidence of foreign investors and enhances a larger amount of investment in the host country.

The growth of the economy measured in GDP has a significant impact on the extent of FDIs that enter into the country. For example, taking China, Sri Lanka, India, and Pakistan. China, which has the highest real GDP, also attracts the maximum amount of investment ($131 billion, 2000-2012), and India has the second rank, while Sri Lanka and Pakistan get the third and fourth positions.

The reason that countries would like FDI is because it boosts financial stability, growth, and development in India. Since liberalization took place in India in the 1990s, there has been a positive impact on the GDP growth rate.

There seems to be a two-way impact on the growth rate of a country and the extent of FDIs that it attracts. The pull factors that have attracted FDI could be stated in the following manner:

- Rapidly expanding consumer market
- Access to other neighboring countries
- Accessibility to cheaper, basic inputs
- Well-developed and stable banking system

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- Favorable policies for foreign investors

The six most important macroeconomic indicators for India are:

- Exchange rate(₹ per $)
- Inflation (Wholesale price Index(WPI), Consumer price index (CPI))
- GDP(gross domestic product)/ IIP (index of industrial production). This is a proxy for market size.
- Interest rate on 91 days treasury bills
- Trade openness/ Trade liberalisation

3.2 On the Political Scenario

For foreign investors to invest in developing countries, the main concerns are government policies that should be stable and transparent to provide a safeguard for the investments that they are bringing into the country. A higher investor's confidence in the domestic market acts as a stimulus in getting an increasing amount of FDI flows.

Amongst the political risks components, the factors that are important :

- Government stability
- Socio-economic situations
- Investment profile
- Internal and External conflict
- Corruption
- Religious tensions
- Democratic Accountability
- Ethnic tension

3.3 The Geo-socio setup

The country receiving the FDIs and FPIs depends upon the level of the country that exists in that economy. It depends on the quality of the economic, political, and social environment as well as the financial system that exists in the host country.

The impact of FDI on growth depends upon the level of income that exists in the recipient economy. If the FDI needs to have a positive impact on the growth of that economy, it is important for the financial institutional framework of the host country to be robust.

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FDI benefits are not automatically accrued, as it depends upon the absorptive capacity in channeling FDI effects.

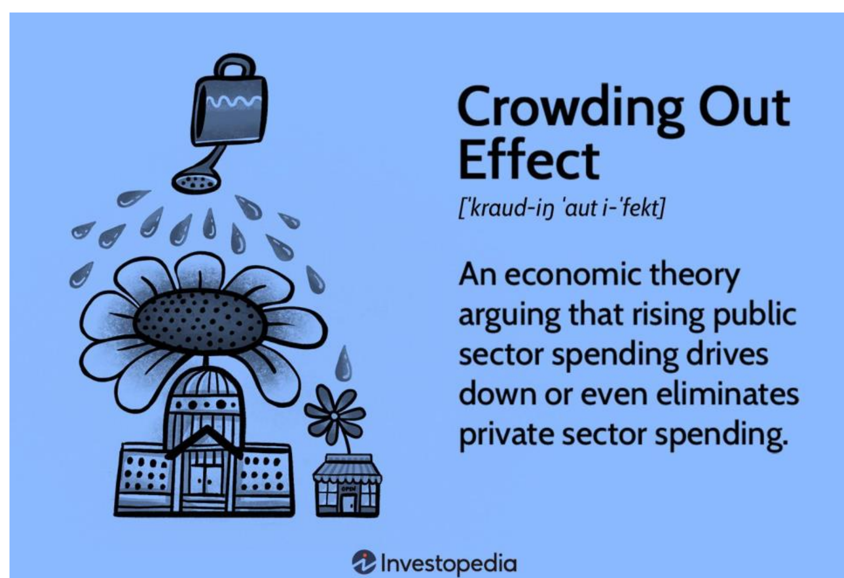
4. Analysis and Importance that all the above three have on the development process of the Nation

FDI started increasing steadily since the early 1990s. Under the neoclassical growth model, as has been propagated by Solow and others, savings is an important component that would encourage investment and thus growth. Under these models, FDI would be a part of an exogenous or external factor that could contribute to growth by increasing investment and/or efficient production processes.

Macro-empirical evidence has indicated that the direct impact of FDI would depend upon the country in which this amount is being invested. Economists have studied the interconnection between FDI and economic growth, both directly through interaction with local human capital and technology gaps. The higher the degree of openness in the recipient country, the greater the positive impact of FDI. There are other studies that have indicated that though FDI and trade have delivered a stable positive contribution to growth, the impact of FDI with human capital and domestic investment may not have always resulted in a significant impact.

The problem that needs to be carefully addressed is whether the FDI is 'crowding in' or a 'crowding out' investment.

Figure 4: Visual representation of crowding out



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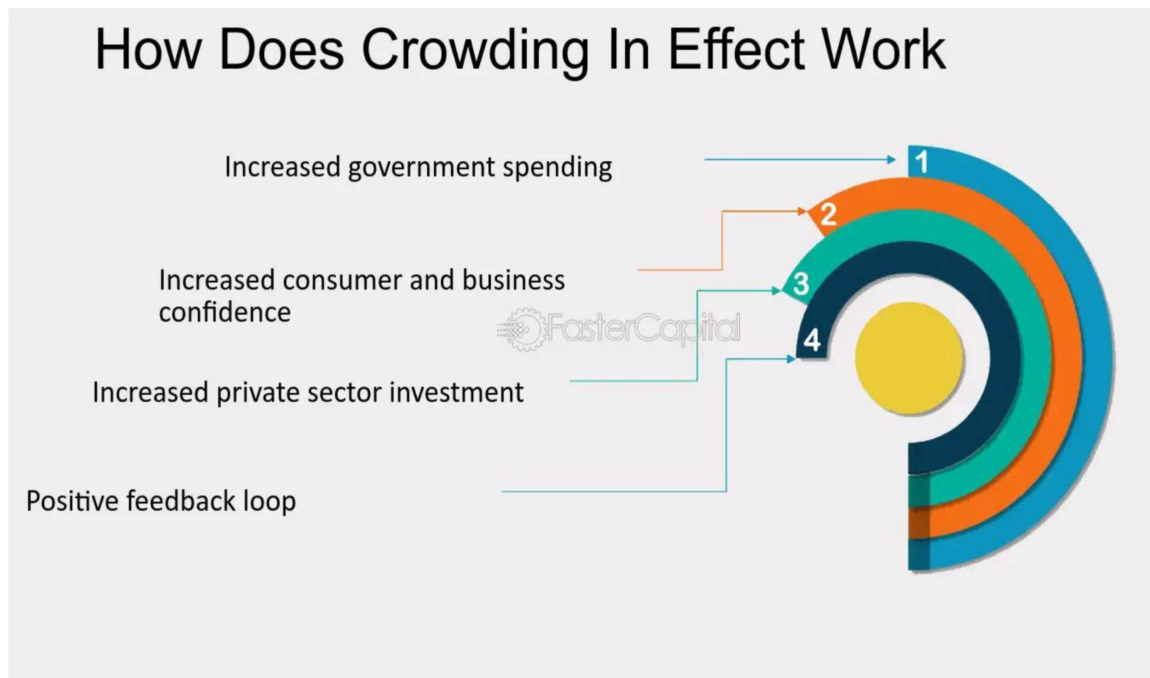
Source: Investopedia

As opposed to the 'crowding out' effect, the 'crowding in' effect works in the following manner

Figure 5: Visual representation of the working of he crowding in effect



Source: Faster Capital

Besides domestic investment impacting growth the crowding-in effect can also be seen to occur when FDI encourages investments by local firms, on the other hand when FDI disrupts investments by domestic entities, crowding-out occurs. Which may not increase the growth of the economy substantively.

5. Impact of FPI on the recipient economy and whether it leads to volatility of macroeconomic indicators

The impact of FPI is directly on the stock market of an economy, and this would lead to extreme volatility in the stock market. The volatility in foreign portfolio investment is measured by using the 'GARCH Model.' This model is used as it responds to shocks in the stock market easily.

FPI is the result of financial liberalization in the world. The world in the 1980s adopted financial liberalization to attract foreign private investors. If the amount of investment enters in the form of FPI, it is known as 'hot money.' FPI enters an economy due to the high interest rate that it can

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earn in that country. The interest rate in the investing company is lower than the interest rate that one can earn in the country that it is being invested in. It is due to the differences in interest rates that FPI enters various developing or developed economies. The main problem with FPI investment is that it brings with it problems of risks, uncertainty, and volatility. International investors tend to invest for short-term benefits, and they withdraw their investment on uncertain conditions. Volatility essentially refers to the uncertainty regarding the flow of FPI.

Devaluation of the host country's currency motivates foreigners to invest due to higher return. The fluctuation in the real exchange rate increases foreign investment volatility. Besides foreign exchange, inflation also impacts the returns on FPIs. High inflation tends to motivate portfolio investors to invest in other countries where inflation is low and return is high. Most of the investment takes place due to high returns that are anticipated. The FPI investors argue that the stock market is an indicator of performance and investor expectation for the host country. A rise in the stock index would increase the stock prices, leading to higher returns for FPI investors.

For developing countries, portfolio flows bridge the gap between giving an investment and providing the much-needed foreign exchange to finance a current account deficit. The investment by foreigners tends to gravitate towards the fastest-growing developing economies like India.

Table 1:US FPI from 2000 in India

Years	Billion Dollars
2000	$14
2005	$67
2010	$128
2015	$379
2020	$14.4 Trillion

Source of Data: Bureau of Economic Analysis (BEA)

Countries like India, due to globalisation and greater linkages of the Indian and international market are affected by developments in the global financial markets. The Indian economy was affected by the Asian prices by the end of 20th century, which led to a reversal of portfolio flows. The sharpest reversal took place in 2008 (The year of the subprime crisis) but there was a

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sharp reversal that occurred in 2009. In fact, equity flows into India in 2010 increased by close to 90% compared to 2009, indicating the confidence of the investor in the Indian economy that may be due to strong domestic fundamentals.

6. Reasons for the increase of FPI and FDI in developing economies

The reasons can be divided into both global and domestic amongst the global factors the most important are the decline in the interest rate in the country that is investing abroad as well as a slowing down in the growth of industrialised economies. These are the primary factors that have pushed capital from developed economies to developing economies.

Amongst the reasons that attract investment in developing economies like India, domestic factors play an important role. These are:-

- **Equity Index -** This is a measure of changes in the market value of a particular group of stocks or equities. Since equity indices represent the market's performance and economic stability , they influence FPIs. While falling indices discourage FPIs, rising indices attract them in by signaling growth and profitability. Additionally, policy changes, geopolitical events, and macroeconomic indicators all affect equity indices. FPI inflows are encouraged by stable or rising indices brought upon by beneficial policies On the other hand, outflows are prompted by volatility or economic instability.

- **Sufficient availability of domestic reserves -** A domestic reserve refers to the financial resources that a nation's central bank reserves to support its monetary policy, stabilize the currency, and fulfill its obligations internationally. It serves as a safeguard against economic shocks. Domestic reservers have a big impact on FPIs because they maintain currency stability and increase investor’s confidence . While low reserves may repel investors because of concerns of financial stability and currency devaluation, high reserves show economic strength and ability to handle external shocks, drawing FPIs.

- **Country credit worthiness -** A country's credit worthiness is their capacity to fulfill its financial commitments, such as paying back debt and honouring contracts. It is determined by their foreign exchange reserves, political and economic stability, fiscal discipline and the amount of external debt. Country creditworthiness affects perceived risk and investor confidence, which in turn impacts FPIs. FPIs are drawn to countries with high credit ratings because they indicate fiscal discipline and economic stability. Conversely, FPIs are discouraged by low creditworthiness since it suggests a greater likelihood of economic instability.

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- **Complementarity between domestic and external factors -** Complementarity between domestic and external factors is when a nation's internal circumstances coincide with advantageous international circumstances, As a result, the conditions are favorable for investments, including FPIs. Favourable external factors like global liquidity and low interest rates, along with strong internal conditions like economic stability, strong policies, and effective governance, increase investor confidence and FPI inflows.

- **Inflation rate -**. Inflation rate measures the percentage increase in the average level of prices for goods and services in an economy over a given time frame, often a year, Because it affects investor confidence and returns, the inflation rate has a big effect on FPIs. High inflation reduces purchasing power and indicates economic instability, which makes a country less appealing to FPI. On the other hand, low inflation, which is a sign of a developing economy, tends to draw FPIs since it shows stability and steady growth, offering investors stable returns.

- **Real exchange rate -** Exchange rate is the rate at which the currency of one nation can be exchanged for that of another. It affects the competitiveness of a nation's assets and returns, which has an effect on FPIs. A higher real exchange rate suggests that a nation's goods and services are more expensive than those of other nations. It may impede economic growth and export competitiveness, which lowers investor confidence and deters FPI. Low exchange rates, on the other hand, can increase exports and economic growth by indicating that a country's goods and services are comparatively less expensive, which attracts FPI to the market

- **Index of economic activity -** Index of Economic Activity (IEA) indicates a country's overall economic performance. Usually, it incorporates a number of economic indicators, including GDP growth, industrial production, employment rates etc. It has an effect on FPI since it provides data on the state of the economy of a country. An increasing IEA indicates economic growth, which increases the country's attraction to FPI. Strong economic momentum attracts investors because it indicates steady returns on investment. On the other hand, a falling IEA suggests possible instability and a decline in the economy. Leading to FPI withdrawals.

- **Share of domestic capital market in the world stock market -** Domestic capital market's share of the global stock market is the proportion of a nation's stock market capitalization to the overall market capitalization of international stock markets. It impacts FPI because a higher market share suggests that a nation's stock market is more linked into the global economy, which attracts investors and results in FPI inflows. A

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lower share in the world stock market, on the other hand, indicates less exposure and less investor confidence, which may put off FPIs.

The main reason for attracting FDI in developing economies are to:-

- Increase employment
- Development of backward areas
- Providing finance and technology
- Increasing exports
- Stabilizing exchange rates

The factors that make India an attractive FDI destination are schemes like:-

- **Make in India-** As part of India's renewed emphasis on manufacturing, the "Make in India" campaign was introduced in 2014. The initiative's goal is to position India as the top destination for manufacturing worldwide
- **Production linked investment (PLI) scheme -** In order to lessen reliance on imports in the field of renewable energy, this program seeks to establish an ecosystem for the production of highly efficient solar PV modules in India.
- **Gati Shakti policies for logistics-** This scheme offers a revolutionary strategy for building India's infrastructure with the goal of establishing a smooth and effective multimodal transportation system.

All the above have been successful in attracting FDI and have opened up more sectors like defence, aerospace and real estate. Macroeconomic factors like freedom of trade, Quality of infrastructure and market size enhances its attraction to FDI .

7. Conclusion

FDI and FPI are extremely important sources of capital investment in a developing economy. It is extremely difficult for these economies to generate the investment required to become a developed nation from domestic sources. FDI is the preferred route to increase investment in the economy, which has linkage effects that automatically increase income levels, reduce poverty levels, and increase employment. The government has to provide adequate policy measures and infrastructure facilities to attract FDI.

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FPI tends to be more volatile, but this can be attempted to be controlled by the government by regulations.

The government of India has framed its policies with special emphasis on rules of entry and exit, operations, functioning, mergers, and acquisitions, and competition, which are important aspects to attract FDI. Besides these, the political, economic, and social stability; international agreements; and trade policies with respect to tariff and non-tariff barriers are equally important in determining the extent of FDI that enters developing economies. The government has also initiated various programs like Making India, Vikshit Bharat, and the PLI (Production Linked Investment) scheme to attract foreign investment.

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