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RBI study on FDI Flows to India

An analysis of the recent trends in foreign direct investment (FDI) flows at the global level as well as across regions/countries suggests that India has generally attracted higher FDI flows in line with its robust domestic economic performance and gradual liberalisation of the FDI policy as part of the cautious capital account liberalisation process. Even during the recent global crisis, FDI inflows to India did not show as much moderation as was the case at the global level as well as in other EMEs. However, when the global FDI flows to Emerging Market Economies (EMEs) recovered during 2010-11, FDI flows to India remained sluggish despite relatively better domestic economic performance ahead of global recovery. This raised questions especially in the backdrop of the widening of the current account deficit beyond the sustainable level of about 3 per cent.

Using Kauffmann's Index, the Reserve Bank of India conducted an empirical exercise to analyse the factors behind such moderation. The study suggested that institutional factors, such as, policy uncertainty, are causing the slowdown in FDI inflows to India despite robustness of macroeconomic variables. A panel exercise for 10 major EMEs showed that FDI was significantly influenced by openness, growth prospects, macroeconomic sustainability, labour cost and uncertainty in government policy. A comparison of actual FDI flows to India *vis-à-vis* the potential level worked out on the basis of underlying macroeconomic fundamentals showed that actual FDI which generally tracked the potential level till 2009-10, fell short of its potential during 2010-11. Further, counter factual scenario attempted to segregate economic and non-economic factors seemed to suggest that the divergence between actual and potential during 2010-11 could partly be on account of policy uncertainty.

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