FDI refers to investment in a foreign country where the investor retains control over the investment. It typically takes the form of starting a subsidiary, acquiring a stake in an existing firm or starting a joint venture in the foreign country. Direct investment and management of the firm concerned normally go together. When a firm controls (or have a strong say in) another firm located abroad, e.g. by owing more than 10% of its equity, the former is said "parent enterprise " (or "investor") and the latter "foreign affiliate". Its definition can be extended to include investments made to acquire lasting interest in enterprises operating outside of the economy of the investor. The FDI relationship consists of a parent enterprise and a foreign affiliate which together form an international business. Since the beginning of the 1990s foreign direct investment (FDI) has become the most important source of foreign capital for emerging market economies (EMEs). In the era of increasingly globalized world economy, FDI is a particularly significant driving force behind the interdependence of national economies. Even though most of the FDI flows have always concentrated in the developed countries, its importance is undeniable for developing countries as well.

Composition

FDI has three components:

a)Equity capital;
b)Reinvested earnings, the investor's share of earning not distributed as dividends by affiliates, in proportion to its share in the equity (say for instance 50% in a certain joint venture);
c)Intra-company loans, when the investor borrows funds to the affiliate, usually without the intention of asking the money back.

To better understand their defining characteristics, we should consider that FDI are flows of capital that share the following features:

a) They are **long-te rm** (in contrast to **portfolio investment** in bonds and in short-term speculation in shares);
b)They give rise to a **property right** on the asset built or bought (in contrast to **foreign aid**).

FDI POLICY AND PROCEDURE

Policy on Foreign Direct Investment

India has among the most liberal and transparent policies on FDI among the emerging economies. FDI up to 100% is allowed under the automatic route in all activities/sectors except the following, which require prior approval of the Government:-

1. Sectors prohibited for FDI
2. Activities/items that require an industrial license
3. Proposals in which the foreign collaborator has an existing financial/technical collaboration in India in the same field
4. Proposals for acquisitions of shares in an existing Indian company in financial service sector and where Securities and Exchange Board of India (substantial acquisition of shares and takeovers) regulations, 1997 is attracted
5. All proposals falling outside notified sectoral policy/CAPS under sectors in which FDI is not permitted

Most of the sectors fall under the automatic route for FDI. In these sectors, investment could be made without approval of the central government. The sectors that are not in the automatic route, investment requires prior approval of the Central Government. The approval is granted by Foreign Investment Promotion Board (FIPB). In few sectors, FDI is not allowed. After the grant of approval for FDI by FIPB or for the sectors falling under automatic route, FDI could take place after taking necessary regulatory approvals form the state governments and local authorities for construction of building, water, environmental clearance, etc.

ROLE OF FDI IN ECONOMIC GROWTH

The most obvious effect of FDI on the growth potential of host countries may be the provision of additional capital. The inflow of foreign funds can help overcome the pervasive investment-saving gap, thus enabling countries to grow faster without sacrificing current consumption.
Indeed in many theories of economic development the main driving force behind a higher growth potential is seen in an expanding capital base. In addition, the investment by one MNE in a foreign firm can induce other MNEs to invest in the same host country as well in order to retain a role as a supplier of intermediate products.

FDI and Capital Formation

The transfer of savings from households and governments to the business sector, resulting in increased output and economic expansion.

Impetus to Economic Growth

The potential for fast income growth has expanded drastically over time. Before the industrial revolution, it took European countries some 350 years for income per capita to double. As the industrial revolution accelerated in the 19th century, Britain, the lead country, was able to double its per capita income in just over 60 years

Domestic labor

Domestic labour may get higher real wages because of increase in productivity.

Consumers

If foreign investment is cost reducing in particular industry consumers of the product may gain through lower product price

Government

The increase in production and trade resulting from foreign capital might increase the fiscal revenue of the government.

External economies

Factors those are external to a firm such as locally available skilled labor, training, research and development facilities.

Tax revenue

Foreign capital investment increases the tax revenue to the government

Foreign investment has assisted and is assisting the economic growth of many countries. As the World Bank report point out, for the developing countries FDI has the following advantages over the official development assistance (ODA)

1. FDI shifts the burden of risk of an investment from domestic to foreign investor.

2. Repayment is linked to profitability of the underlying investment, whereas under debt financing the borrowed funds must be serviced regardless of the project cost.

3.It has also been observed that FDI is the only capital inflow that has been strongly associated with the higher GDP growth since 1970

The contribution of FDI to economic growth is highlighted by the fact that the ratio of FDI flow to domestic investment (gross capital formation) rose for most developed and developing countries in the past. Apart from the potential gains though technology transfer, FDI has generated large employment opportunities in a number of countries.

It will obviously stimulate economic activity in the country. Employment numbers will go up. Existing domestic producers will have to pull up their socks due to the onset of high quality competition. The international community will sit up and take notice. Companies with Foreign investment generally tend to be most profitable as well as it is to have a more stable sales and earnings.

Indian economy has reached in the orbit of high rate of economic growth. FDI inflows have been increased in the post-reform period and India now seems to be quite attractive place for such kind of investments. FDI has come in the most capital intensive sectors, therefore, the desired employment opportunities could not be created especially for the manual and the semi skilled labor. High skilled labor gained substantially.

That is why high growth is called urban centric and thus has created a wedge between the rural and urban economy.

Trade has traditionally been the principal mechanism linking national economies in order to create an international economy. FDI is a similar mechanism linking national economies; Therefore, these two mechanisms reinforce each other. The trade effects of FDI depend on whether it is undertaken to gain access to natural resources, to consumer markets or whether the FDI is aimed at exploiting location comparative advantage or other strategic assets such as research and development capabilities. Companies are rapidly globalizing through FDI to serve new markets and customers, map out their value chains in the most efficient locations globally, and to access technological and natural resources. A country can only grow if the Govt. policies allow more participation and is able to attract more and more foreign direct investment in India. Today, India provides highest returns on FDI than any other country in the world.