Original Article

Analysis of Foreign Direct Investment in Indian Services Sector

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Abstract - After the LPG reforms that the Government of India undertook in the year 1991, there was a drastic change in the functioning and growth of the Indian economy. Many things were removed like licenses, limitations and caps on foreign investment to many sectors in the economy. The sector that benefitted the most from this restrictive withdrawal by the government was the Services Sector. This study has tried to identify the determinants of Services sector FDI and also to inspect any long-run relationship between the variables used in the study. For the analysis undertaken, the time period taken into consideration is from 2001 to 2017. The techniques used in the study include Ordinary Least Squares, Johansen Co-integration. The empirical analysis concludes that Gross Domestic Product, Bombay Stock Exchange, Expenditure on Infrastructure has a positive relationship with the Services Sector Foreign Direct Investment. Exchange rate and Inflation have a negative relation with the Services Sector Foreign Direct Investment. From the policy perspective government should increase expenditure on infrastructure and take care of fluctuations in the exchange rate and inflation, thereby relaxing the restrictions on the inflows of FDI into the Services sector helps the service-led economy like India to boost its performance.

Keywords - Service Sector FDI, GDP, Inflation, Expenditure on Infrastructure, Exchange Rate.

I. INTRODUCTION

The World Bank defines Foreign Direct Investment as: "Foreign direct investment are the net inflows of investment to acquire a lasting management interest (10 percent or more of voting stock) in an enterprise operating in an economy other than that of the investor. It is the sum of equity capital, reinvestment of earnings, other long-term capital, and short-term capital as shown in the balance of payments."

For every economy, there are three sectors. They are agriculture, industrial, and services sectors. The services sector is also known as the "Tertiary Sector". The Indian service sector played a key role in the growth of India's Gross Domestic Product (GDP). The services sector, in general, produces the service and not the end product or finished good, which can be held in hand. Activities involved in this services sector are spread far across the despicability.

In this study, the Services sector includes all the sectors other than the sectors that are involved in the agriculture and industrial sector. Various sectors included in the services sector are Banking and Non-Banking sector, Telecommunication sector, Construction sector, Railways sector, Insurance sector, Tourism, Entertainment, medicine, Engineering, Computer software, non-profit economic activity, Defence, all government services, etc.,

According to the "UNCTAD (United Nations Conference on Trade and Development)" survey, India stood as the second-most attractive nation among all the countries in the world after China where the major investors are from the USA, UK, Mauritius, etc.,

India Services Sector played a significant role in India's performance in terms of its growth and development. The share of the services sector in the country's GDP has approximately doubled from the time of independence.

In recent years, the Indian economy grew at an anomalous rate. The figures show that there is a large growth in the Indian economy in the recent past. Unlike the other emerging economies, such as China, where the growth in the economy was led by its huge manufacturing activity, India's economic performance was led by services.

A. Objectives
1. To identify the determinants of Services sector FDI.
2. To check whether there exists any long-run relationship between the variables.

B. Limitations of the study
The above study is limited to the time period of seventeen years that is from the year 2001 to 2017. Prior to the year 2001, the data is available as only decadal data. So the results drawn from the above study are subjected to the above limitations.

II. LITERATURE REVIEW
Dhanraj Sharma and Ruchita Verma (2017) examined the impact of specific determinants on

Foreign Direct Investment of the services sector in the most recent ten years that is from 2006-07 to 2016-17. The variables used in the study are services sector FDI Equity Inflows, Gross Domestic Product (GDP), Inflation rate, Trade Balance. The results of the paper reveal that the service sector enjoys the leading destination for foreign investors in the last decade as compared to other sectors. Multiple regression models showcased that Trade Balance and GDP are found to be significant factors that have a considerable impact on service sector equity inflows.

Vanita Tripati, Ritika Seth, and Varun Bhandari (2012) have used exchange rate, inflation, Index of Industrial Production, Gross Domestic Product, Interest rate, Trade openness variables to check the impact of the above macroeconomic factors on the FDI inflow by taking quarterly/ annually data. The data of the above variables have been analyzed using various econometric techniques such as ADF, PP unit root stationarity test, Bivariate and Multi-Variate Regression analysis, Vector Auto Regression models. They erudite after performing the study that FDI and macroeconomic factors (except for exchange rate) projected a high correlation. The VAR result showcased that FDI is caused more by its past values than FDI is caused more by its past values than lagged values of other macroeconomic variables. The presence of favorable relation between FDI and profitability indicates a higher investor's confidence in the domestic market.

Priya Dwivedi and Jyoti Badge (2013) studied the relation between FDI in the services sector and Gross Domestic Product for the period 2002 to 2012. The author had conducted different tests such as Correlation, Goodness of Fit test, ANOVA, Regression, etc.; the results of the above study are limited to the above time period ran to extract the result. The authors have shown the results of the study as there exists a positive relation and significant impact of foreign capital inflows on the Indian economy.

Arjun Singh Sirari and Narendra Singh Behra (2011) analyzed the importance of FDI inflows in the Indian Services Sector from 1991 to 2010 and also learned the relationship between services sector growth and the Indian economy. The author speaks of the Services sector's contribution to the Indian Economy. They explain the relation between FDI and Economic Growth, that is, FDI helps increase the inflow of Money in the Economy, which intern helps the processing of Economic Resource, leading to Employment Generation of both kinds that are skilled and unskilled, which helps to increase their disposable income. The authors have observed from the results of the study that, in the services sector of India at the sectoral level, FDI has helped to raise the Total production productivity and employment for a skilled worker with high perks.

Narender Yadav (2014) revealed that FDI inflows had shown Overall significant growth, which has

improved close to 6% from 2000 to 2014. The growth of the services sector declines up to 2.67% and reaches near to 54.59% and raises to 57% in the year 2013-14. The current study by the author showed a significant positive impact of foreign capital inflows on Indian economy sectors.

Shivani Dixit and Anjana Sharma (2014) emphasized on implications of Services sector FDI in India. Half the GDP of the Indian economy is being contributed by the services sector. In recent years it has increased to more than 50%. The inflow of FDI has helped several industries in the services sector such as Telecommunications, Hostel, and Tourism, etc.; India is known as a "Service hub" to the world because of huge FDI inflows into the economy.

Gurmeet Singh (2016) explored the relations between foreign direct investment (FDI) and Gross Domestic Product (GDP) for the time period 1975 to 2013. Granger causality and Johansen's co-integration have been implemented to realize the direction of causality and the long-run relationship between the above-mentioned variables. The study of the author does clinch that FDI does have an impact on Indian GDP. However, the study by the author is limited to one macroeconomic variable.

M.Sumathy and L.S.Sridhar (2014) investigated the FDI inflows in India, particularly to the Services sector. The period of study is from 2000 to 2014 using time series data. The attempt by the author was mainly to see the relation between GDP with FDI flows. After running the trials, the author of this paper concluded that there exists a positive relationship between GDP and FDI inflows. The author also highlights that the service sector is attracting FDI more than any other sector in the country. They also found that GDP is being boosted by FDI.

III. DATA AND METHODOLOGY

The present section presents the sources of database utilized and methodology applied to get empirical analysis results. The construction of relevant variables for the Co-Integration Analysis.

A. Data and Construction of Variables

For the analysis purpose, time-series data on various variables have been called out from RBI Hand Book of Statistics, World Bank, Department of Industrial Policy and Promotion. The main variable is the SFDI. Further, for regression analysis, data of five variables have been used from 2001 to 2017 have been used.

Table 1: Description of Variables Used for Analysis.		
Nature of Variable	Notation used	Variable name
Dependent	FDI	FDI in the services sector
Independent	GDP	Gross Domestic Product
	Infra	Expenditure on Infrastructure

	ER	Exchange Rate
	BSE	Bombay Stock Exchange
	INF	Inflation

For the analysis purpose, all variables have been taken directly in values and interpreted in proportionate terms.

The variable GDP, BSE, INF, ER has been taken directly from the RBI Hand Book of Statistics. Further, the variable Infra that is Expenditure on Infrastructure has been taken directly from The World Bank data. The data of SFDI has been taken from DIPP. The sample of the data has been taken from the year 2001 to 2017. The reason for choosing only from 2001 and not prior to 2001 is because the data prior to 2001 the data is available only as decade data.

B. Methodology Used

For the empirical analysis, a study has utilized two main methodologies to explain in detail the role of the services sector in the Indian economy. The following two sub-sections explain them in detail.

C. Regression Analysis

In Regression Analysis, we use historical data to infer the results. We used the Ordinary Least Squares (OLS) method in Regression analysis for our empirical analysis. We have also used the Co-Integration test to see the long-run relation between the variables. Here we have used Johansen Co-Integration and not Engle and Granger Co-Integration because we are seeing the long-run relation between four variables that is my dependent variable and three independent variables. Engle and Granger Co-Integration test is used to see long-run relation between two variables.

D. Johansen Co-Integration

The Engle-Granger methodology is not a suitable one to test for co-integration. Here in this circumference, one can rely on the Johansen test for cointegration which is a matrix-based approach. However, the condition is that the variables in the model should be I(1). "The Johansen test can be seen as a multivariate generalization of augmented Dicky Fuller test. The generalization is the examination of a linear combination of the variables for the unit root test." The Johansen test and the estimated strategies caked the maximum likelihood methodology to estimate the co-integration vector when there are more than two variables. When the variables are stationary at the levels, then one need not check for the co-integration of the variables. For example, if there are two variables, then β is a 2x1 matrix (vector), and α will also have the same model.

The two coefficients in the cointegrating vector $\beta^{\wedge\prime}$ multiply the variables to deliver the linear combination of variables that do have a unit root.

The two coefficients, one in α, are the two adjustments coefficients, one for each of the two equations. If the matrix of π equals the matrix of zero's, i.e. (π=0), then the variables are not cointegrated, and the relationship reduces to VAR in the 1st differences.

The next question is how to check whether π is equal to zero or not. One way could check whether the rank of π=0. The rank is the number of linearly independent columns and rows in the matrix. Therefore, if the rank of the matrix is equal to zero, then we can conclude that the co-integration is zero. If the variables are co-integrated, then the Rank of π matrix should be non-zero, and the rank pf matrix π will be equal to the number of cointegrating vectors.

In a cointegrating relation of n variables, we can have only n-1 cointegrating relations. The Johansen test centers around the nature of the π matrix. Let r be the rank of the π matrix in the Johansen test. We check for the maximum Eigenvalue and the trace test. "The Johansen test is the likelihood test for both test statistics the initial Johansen test is the test of null hypothesis where a null hypothesis of no cointegrating is tested against the alternative Hypothesis of one cointegrating relation."

IV. EMPIRICAL ANALYSIS

The variables used in the study are SFDI, INF, Infra, BSE, ER, GDP. The unit root test result of the above variables are as follows:

Variables	Level	1st difference	2nd difference	Inference
	I(0)	I(1)	I(2)	Stationary
FDI	0.764	0.020	-	I(1)
GDP	0.922	0.091	0.019	I(2)
ER	0.670	0.019	-	I(1)
BSE	0.084	0.009	-	I(1)
Infra	0.876	0.019	-	I(1)
INF	0.252	0.045	-	I(1)

A variable is said to be stationary when the estimated value is less than the critical value at various significance levels, i.e., at 1%, 5%, and 10%. All the above-mentioned variables are stationary at the first difference, i.e., integrated of the order I (1) except the variable GDP, which is integrated of order I(2).

A. Model Specification

In this section, before going to the empirical model, we discuss the apriori relationship between the variables as suggested by the economic theory and also the relationship ascertained from the various literature reviews, which was reviewed to carry forward the analysis.

SFDI = F (GDP, ER, BSE, INFRA, INF)
           (+)   (-)   (+)   (+)   (-)

Here we see that foreign direct investment into the service sector is attracted by some of these variables. We know that if the country's economy is growing,

then it attracts more investment's into the country as the investors' confidence in the performance of the economy rises. However, investments into a particular sector depend on the performance of that sector respectively. As the GDP of the economy increases, there will be a rise in the production of the economy, leading to an increase in job opportunities which helps to raise the income of the individuals. As the income of individuals increases, there will be raise in demand for various products and services in the country, which makes investors invest in the country.

As the INF in the economy increases, there will be a rise in the prices which leads to an increase in the cost of raw material which makes give more wages to its employees, and there will be a rise in the overall cost of capital which makes foreign investors repel in investing in the country.

As the Infra increases, it helps to raise trading activities, transport activities, all service activities, which makes all business activities function smoothly. Foreign investors are attracted to invest in the country when there is the smooth functioning of business activities or trade activities. Thus expenditure on Infrastructure helps the country in attracting foreigners to invest in the economy.

As the BSE Sensex increases, it means that there is a raise in the business activities of all the companies that are listed in BSE Sensex, which makes the Foreign Investors invest in Indian companies. Thus there exists a positive relationship between BSE Sensex and FDI inflows.

As the ER depreciates, it attracts more and more foreign investments into the nation. As it appreciates, it creates disinterest among the foreign investors as the rupee is becoming stronger, the cost bore by them will be more, vice versa if the currency weakens, it attracts foreigners to invest more in India since the cost of currency is very minimal. Thus there exists a negative relation between the Exchange rate and FDI. The relation between FDI and ER is ambiguous.

Model 1

D(SFDI) = -688.0417 + 23.19*D(GDP) - 88.39*D(INF)

(-1.39)   (5.373)   (-2.809)

+ 2669.97*DUM

(8.74)

R-SQUARED = 0.89

ADJUSTED R-SQUARED = 0.86

D-W STAT = 1.73

F- STAT = 32.53

From the above result of R-Square = 0.89 and Adjusted R-Square = 0.86, we can understand that 89 percent of the dependent variable is being explained by the independent variables. An Adjusted R-square of 0.86 tells us that we need not worry about the loss of degrees of freedom and the current model is a good fit. The overall significance of the model is given by the F-statistic. The F-Statistic value of 32.53705 is significant, which implies that the overall model is

good and fits with the population of the sample data, and we can reject the null hypothesis that all the coefficients of the explanatory variable are simultaneously zero. The Durbin Watson stat is 1.73, which is a closer value to the ideal value of 2; we can accept the model even though there is a presence of some autocorrelations in the model.

Now we look at the relationship between the individual variables. Going by the t-static value, we find that all the explanatory variables are individually significant in determining the dependent variable. Since the model is in the actual value of the coefficients, the individual variable tells us what will be the change in the dependent variable (SFDI) for one percent change in the explanatory variables. Coming to the estimated model, we find that the coefficients used in the above equation have signed are according to the economic theory. Variable GDP has a positive relationship with the dependent variable, and INF has a negative relation with SFDI. GDP has a positive coefficient of 23.19, which means that for a given change in one unit of the independent variable that is GDP, there will be 23.19 times change in the dependent variable that is FDI in the services sector. Inflation has a negative coefficient of -88.39, which means that for a given change in one unit of the independent variable that is Inflation, there will be 88.39 times change in the dependent variable that is FDI in the services sector.

B. Stability Test

The parameters of a good model have to be stable across various subsets of the given data, and this is tested using the stability test in OLS estimation. This is done by looking at the recursive residuals. For the model to be stable, the residuals have to stay well within the standard error bands. In the year 2009, the residual is out of the standard error bands is majorly due to the "GLOBAL FINANCIAL CRISIS" that India underwent in the year 2007-08, because of which there was a major change in the investment pattern in the Indian economy of the year 2009. There is a lag effect in the investment pattern by the foreigners. If India performs this year well in all aspects of the country's growth and developments, then the investment by foreigners will be very high in the following year. Similarly, if India was hit with a crisis in a particular year, then the following year, investments by foreigners will be decreased. Due to the above reason, the residual is out of the standard error bands in the year 2009. Rest all the years; the residual is within the standard error bands.
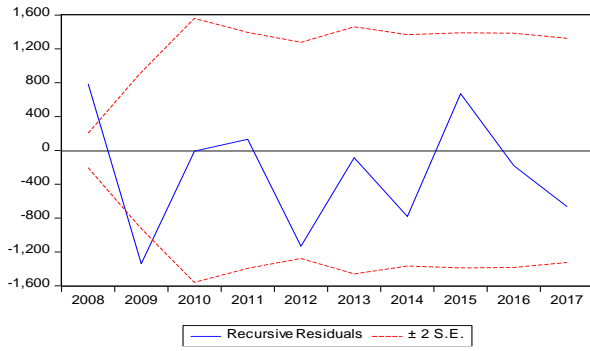
Fig. 1 Stability test

Source: Author's calculation

Model 2

$$D(SFDI) = -790.51+0.025*D(Infra)-358.99* D(ER(-1)) +0.42*D(BSE)+2920.47DUM$$

(-2.014)   (4.327)   (-3.728)

(3.458)   (4.796)

R-SQUARED = 0.81
ADJUSTED R-SQUARED = 0.74
F-STATISTIC = 11.09
DURBIN WATSON STAT = 1.73

From the above result of R-square = 0.81 and Adjusted R-Square = 0.74, we can infer that the dependent variable that is fdi in service sector 81 percent is being explained by the independent variables or explanatory variables. An adjusted R-Square of 0.74 tells us that we need not worry about the loss of degrees of freedom and the current model is a good fit. The overall goodness of fit is given by F-statistic. The F-statistic value in the above regression is 11.09554, which implies that the overall model is good and fits with the population of the sample data, and we can reject the null hypothesis that all the coefficients of the explanatory variable are simultaneously zero. Since the Durbin-Watson stat is 1.73, which is closer to an ideal value of 2, we accept the model even though there is a presence of mild autocorrelation in the model.

Expenditure on Infrastructure (Infra) has a positive coefficient of 0.025, which means that for a given change in one unit of the independent variable that is Infra, there will be 0.025 times change in the dependent variable that is FDI in the services sector. Exchange Rate (ER) has a negative coefficient of -358.99, which means that for a given change in one unit of the independent variable, that is, the Exchange rate (ER), there will be -358.99 times change in the dependent variable that is FDI in the services sector. Bombay Stock Exchange has a positive coefficient of 0.42 which means that for a unit of change in the independent variable (BSE), there will be a change of 0.42 times change in the (FDI in Services Sector) dependent variable.

Now we look at the relationship between the individual variables. Going by the t-static value, we find that all the explanatory variables are individually significant in determining the dependent variable. Coming to the estimated model, we find that all the

coefficients signs are according to the economic theory. Variable expenditure on Infrastructure (Infra) and Bombay Stock Exchange (BSE) has a positive relationship with the dependent variable, and the Exchange rate has a negative relation with the dependent variable. Stability Test

The parameters of a good model have to be stable across various subsets of the given data, and this is tested using the stability test in OLS estimation. This is done by looking at the recursive residuals. For the model to be stable, the residuals have to stay well within the standard error bands. In the year 2016, the residual is crossing the standard error bands due to the major reform by the Indian government that is Demonetisation of Indian currency of Rs.500/- and Rs.1000/- Due to the implementation of Demonetisation by the Indian Government there was a huge hit to the GDP in that particular year to the Indian economy.
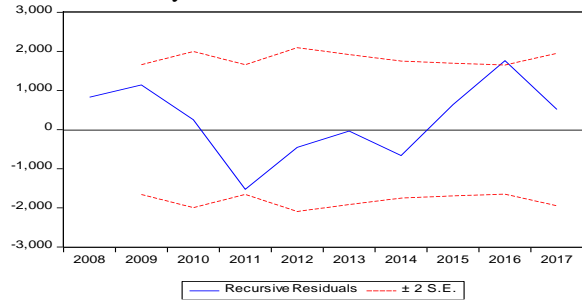

Fig. 2 Stability test

Source: Author's calculation.

C. Johansen Co-Integration Result

The below table gives the results of the Co-integration test based on Johansen's Maximum likelihood method. The values under the Trace statistic and Max Eigen Value are the calculated values, and the values in the brackets are the critical values at the 5% significance level. Both trace test and maximum Eigenvalue statistics indicate that there are at least two co-integrating vectors among SFDI, Infra, BSE, ER (-1).

Results of Co-integration Tests for SFDI, Infra, BSE, ER(-1)		
Null hypothesis	Test Static Value	
	Trace Statistic	Max Eigen Value
r = 0	70.56 * (47.85)	37.69 * (27.58)
r = 1	32.86 * (29.79)	22.17 * (21.13)
r = 2	10.68 (15.49)	8.59 (14.26)
r = 3	1.73 (3.84)	1.73 (3.84)

In the above table, the calculated value is greater than the table value at r=o and at r=1. "The actual maximum Eigenvalue statistics rejects the null hypothesis that there is no co-integration between the variables, i.e., r = 0 at the 95 percent confidence level. In favor of the alternative hypothesis that there is at least one co-integrating vector, i.e., r = 1. Both the Trace Statistic and Max-Eigen Statistic from the Johansen Co-integration test indicated two co-

integrating equations confirming a long-run association between the variables. The calculated values at r = 2 and at r = 3 are not greater than the table values at both trace statistic and Max Eigenvalues. So there is the long run relationship of not more than 2 co-integrating vectors."

V. CONCLUSION

The Indian Services sector plays an important role in the development of the Indian economy. Among the three sectors in the Indian economy (that is, the Agriculture sector, Industrial sector, and Services sector). The contribution of the Service sector to India's GDP is the highest compared to all other sectors. Among the various sectors in the Services sector, Banking and Non-Banking Corporations attract the highest FDI compared to all the other sectors.

In this study, we have used annual time series data from 2001 to 2017 to empirically analyze the relationship between the FDI and Gross Domestic Product (GDP), Exchange rate (ER), Expenditure on Infrastructure (Infra), Bombay Stock Exchange Sensex (BSE), Inflation (INF) through Ordinary Least Squares Technique. From the empirical analysis, we conclude that Gross Domestic Product (GDP), Expenditure on Infrastructure (Infra), Bombay Stock Exchange (BSE) has a positive impact, whereas Exchange rate (ER) and Inflation (INF) has a negative relation with the FDI in Services Sector.

In order to see the long-run relation between SFDI and independent variables, we have employed Johansen Co-integration, and the results showed that there exist two co-integrating equations confirming the long-run relationship between the variables.

Increasing GDP has a positive relation with FDI in the services sector and can lead to attracting more and more FDI into the Services Sector. An increase in Infra has a positive relation with FDI in Service Sector. The increase of expenditure on Infrastructure attracts foreigners to invest more and more capital into the economy. An increase in BSE has a positive relation with FDI in India. With the increase in the BSE, there is a rise in FDI invested by the foreigners because of the increase in the faith of the foreigners in the Indian Companies, which are listed in the BSE Sensex. Depreciation in the Exchange rate can lead to a decrease of FDI in the country because of loss of faith in the currency. With the fear that it may further depreciate, the foreign investors may show disinterest in investing, which leads to a decrease in the FDI inflows. If there is high inflation in the country, the cost of capital will become costlier, which discourages foreign investors from investing in the country.

All these factors considered for the analysis can have an indirect impact on Services FDI. Consequently, the Government of India must pay attention to the problems like lack of Infrastructure facilities, providing tax holidays to encourage business activities in the economy, control of Inflation in the country, Steady growth in the GDP of the nation, a persistent exchange rate of the economy under all circumstances. The Indian Banks have proved a steady performance even during the Global Financial Crisis majorly due to the norms laid by the Reserve Bank of India and by strictly following BASEL norms which lead to the huge inflow of FDI into the Banking Sector, which is part of Indian Services Sector. A long-run increase in GDP, Infra, BSE can help the Indian economy to attract the FDI into the Services sector at a huge volume. Also with the control over ER and INF can bring stability to the growth of the economy. Thus India can experience the benefits from the FDI by increasing the Favourable variables and can mitigate the loss of disinvestment into the country by controlling the Exchange rate and Inflation in the country.

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