FOREIGN CAPITAL AND ECONOMIC DEVELOPMENT: A CASE STUDY OF INDIA

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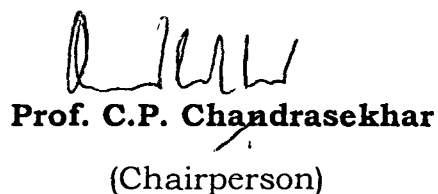
CERTIFICATE

This is to certify that the dissertation entitled "**Foreign Capital and Economic Development: A Case Study of India**" submitted in partial fulfilment for the **M.Phil** degree of this university has not been previously submitted for any other university and is my original work.

Pawan Kumar

We recommend that the dissertation may be placed before the examiners for evaluation.



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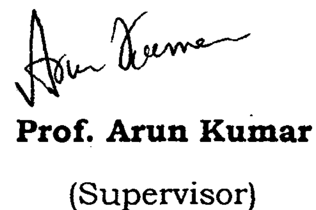

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Pawan Kumar

Dedicated

to

My Mummy & Babuji

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Chapter I

INTRODUCTION

INTRODUCTION

Whatever development model is adopted by any country, the finance is a crucial factor everywhere. Similarly, self reliance may be considered a cherished goal and international trade and financing in some form or the other is always desirable. For developing countries, the ability to draw upon the international pool of financial capital may result in large potential benefits. Economic growth in these countries is believed to be constrained by lower level of capital per worker. Foreign capital can be used to augment their private saving and to reach high rates of capital accumulation and growth.

It is also argued that some type of foreign investment, principally foreign direct investment (FDI), facilitate the transfer of managerial and technological know-how. Some proponents have gone on to argue that, by increasing the reward for good policies and the penalties for bad policies, the free flow of capital across national borders has the salutary effect of promoting more disciplined macro economic policies and reducing the frequency of policy errors. By mid 1990s, support for open financial markets had gone to the extent that some officials of IMF suggested amending the IMF charter to make capital account convertibility (CAC) mandatory for all member countries, the way current account convertibility is done.

However, the opening up of the domestic market for foreign capital creates added risks, as evidenced by the frequency of crises in both developed and developing countries. Untill the Mexican crisis in 1994, these crisis were more often blamed on incorrect macro economic policies in affected countries or what is characterised as

bad fundamentals. But after South East Asia (in 1992) and Argentina in 2001 countries have faced crisis, the focus has now shifted to the inherent instability of financial markets, and the risks that foreign capital inflows can create for countries with relatively unsophisticated and weak regulatory mechanism.

Most of the current policy discussions implicitly accept that open capital markets are highly beneficial and proposals for reform have been directed towards reducing the risks of financial instability and crisis. Among the policy makers there is a strong belief that crisis can be prevented by a free flow of information and by improved surveillance of financial market. Thus there have been calls from the proponent of foreign capital flows for greater transparency with respect to the actions of Central Bank and the short term debt and foreign exchange exposure of private banks and corporations. Steps have also been taken to improve the response to crisis (UNCTAD, 2000).

In India, economic reforms started in 1991, following severe balance of payment crisis. In many South American countries in the 1980s, the macro economic crisis became also the occasion for undertaking substantial (or sometimes called structural adjustments) reforms that had been long overdue. India adopted 'Washington Consensus' promoted and sponsored by IMF and other international financial institutions. Later, by accepting the membership of WTO, India intensified its reform programme for both trade and investment. Since then reforms have been Part and parcel of policies of every government that has come to power, independent of

the political ideology. On foreign investment fronts, the Industrial Policy of 1991 states, "... the new policy welcomes foreign investment with its attendant advantages of technology transfers, marketing expertise, introduction of modern managerial techniques in the country and export promotion" (GOI, 1991). These structural reforms in India were necessary because we had evidently failed to generate adequate rate of growth of income and of per capita income, that put India behind many developing countries and way behind the super performers in the Far East (Srinivasan and Bhagawati, 2000).

Foreign capital may take any of the following forms: external assistance, external commercial borrowings, NRI deposits, FDI and portfolio investment. Soon after independence, policy towards foreign investment was largely conditioned by two factors : Industrial Policy Resolution (IPR) of 1948 and 1956 and the balance of payment considerations, especially in late fifties. This conditioning continued throughout the period till 1980s. Foreign private capital in requisite quantity did not flow to India before 1991. During 1969, more precise policy towards foreign investment (mainly FDI) was announced. Under it three groups of industries came up. First, FDI without technical collaboration. Secondly, only technical collaboration. Thirdly, no foreign participations. All of these were followed by introduction of FERA in 1973. The main idea behind the foreign investment policy was to restrict foreign investment to sectors producing intermediate and capital goods and discouraging it in consumer goods industry (Chandra, 1991). During 1980s foreign investment and trade were further liberalised.

What have been the results of investment policies in the 1970s and 1980s? What was the type of foreign investment in the 1970s and 1980s, and what was its source? Why there was a change in the pattern of foreign capital inflows during the mid-1980s? What were the reasons that gave rise to economic reforms in July 1991and what were the results of it? These are some of the issues we would examine in the forthcoming discussion. As we mobilised more and more FDI and portfolio investment in the 90s, was there a favourable impact on economic development?

During the 1950s, India and China, had similar level of economic development (growth, per capita income, employment, sectoral growth, etc). However, now a wide gap has opened up between them in terms of their economic achievements. China, is ahead of India in trade, investment and economic growth. It stands second after USA in foreign investment inflows (this figure was $42 billion in 2000-2001). What are the driving forces behind China's unprecedented achievements and where India has gone wrong in its reform programme? Is there any thing that India can learn from China's experience?

1.1 Empirical Studies on FDI and Growth

There is relatively small empirical literature on whether the potential benefits to recipients of capital inflows, are realised. Many of these studies are either inconclusive or have failed to find strong evidence of benefits from capital inflows. One approach has been to focus on plant level data in specific countries, such as the work by

Horrison (1996), however, she finds little evidences that FDI itself increased productivity. Another approach has been to simply compare investment and/or growth rates during the period identified as having limited capital mobility with investment/or growth rate during periods identified as having relatively high capital mobility. This work tends to conclude that increased capital mobility has been associated with decline in rates of investment and growth, but the results are not very persuasive. Grouping by period does not adequately distinguish experiences of large versus small capital inflows. Further, it is not at all clear that differences in economic performance across periods should be attributed to difference in capital flows (Bosworth, 1999).

A third approach compares economic performance of countries with capital account restriction versus countries with open capital accounts. This approach can provide information about the effects of policy changes, recent work along these lines such as by Rodrik (1998). However this work sheds little light on the implications of actually receiving capital inflows because, the standard IMF indicator of capital account liberalisation is a poor proxy for the extent to which countries actually receive capital inflows.

Soto (2000) analyzed the impact of various forms of foreign private capital inflows on growth for a panel of 44 developing countries during the 1986 to 1997 period. He found that both FDI and portfolio equity flows show a positive robust, and significant relationship with income growth. However, short and long term

bank-related flows exhibit a robust negative correlation with growth when domestic banks have low capitalisation ratios.

Dutt (1997) formulates a model of FDI flows from North to South which shows that FDI flowing to sectors in the South which compete with Northern production have a greater positive impact on growth than flows to sectors which compete with Southern domestic sectors because of worsening Southern terms of trade in the latter case. He further theorizes that the shift in attitude towards FDI in developing countries may be at least in part due to a change in the sectoral pattern of FDI which have enhanced the positive effects of FDI and reduced the negative ones. There have certainly been very significant changes in the sectoral patterns of FDI to LDCs. In the early 20th century, more than half of all FDI flows to LDCs went to the primary sector, mainly mining and agricultural raw materials, while only 10 percent was invested in manufacturing. In 1990, 40 percent went to manufacturing, 50 percent to services, and 10 percent to the primary sector (Dutt 1997). However, in a cross-country growth regression of less-developed countries for the period 1985 to 1994, Dutt found no statistically significant differential effect between FDI flowing to primary, secondary, and territory production sectors. In fact, Dutt a negative statistically significant effect of FDI stock on growth.

De Mello (1997) also reports evidence of a development threshold hypothesis in his survey of FDI - growth related literature. The statistically significant positive impact of FDI on growth is stronger for countries with a higher level of development. He

postulates that a threshold level of development must be attained before a country can reap the benefits of higher productivity investment fostered by foreign investment. If the development threshold has not been reached the benefits of FDI may only impact the particular industries in which it operates.

Another line of research examines the impact of FDI on growth under different policy-related environments, such as more open trade regimes. By including exports in the augmented production function, Balasubramanyam et al (1996) find that FDI has a greater positive impact on growth in countries promoting exports compared to countries exhibiting import substitution strategies.

1.2 Empirical Studies on FDI and Trade Dynamics

Most empirical work relating to the export performance of TNC (or FDI) has focus on the manufacturing sector. The majority of studies have adopted a comparative methodology by analyzing the export performance of matched pairs of foreign and domestic firms, or by including foreign ownership along side other relevant independent variables in a multiple regression or discriminant analysis where the dependent variable is the export performance.

In the context of TNCs, the debate in LDCs too has generally centered on the relative performance of domestic and foreign owned firms. While, one set of studies argues for a superior export performance for TNCs (see for example, Willmore, 1976, for Costa Rica; Santiago, 1987; Lall and Mohammed 1983, for India). Another set of studies indicate no significant differences (see Nutse and

Newfarmer, 1985, for Brazil; Lim, 1976, for Malaysia; Kumar, 1996, for India). Reidel's (1975) analysis of six export oriented industries in Taiwan suggested that in only one of the six industries (electronics) were foreign firms significantly more export oriented than domestic firms. In contrast a study by Jenkins (1977) for Mexico found, that local firms had a better export performance in traditional and intermediate goods but the foreign firms performed better in the engineering goods industry.

A review of empirical literature by Fontagne concludes that at the macroeconomic and sectoral level, empirical studies generally support complementarities between FDI and trade (Fontagne 1999). McCorriston (2000) also notes that generally trade and FDI have been found to be complementary in the empirical literature.

In 1994, Hufbaur et al. (1994) assess the effects of FDI stock on merchandise trade for the United States, Japan and Germany. They find inconsistent results across countries and time periods. Japan is the only country where outward FDI consistently raises imports more than exports.

Goldberg and Klein (1998) focus on trade and FDI between the USA and Japanese investments in Southeast Asia and Latin America. For the period 1979 to 1995, they find a full range of effects and conclude that it is not possible to make any systematic conclusions from their analysis.

Thus there seems to be no clear consensus on the relative export performance of TNCs and domestic firms. This, however, is

not surprising as export performance is not a function only of the degree of foreign ownership. In particular, an export function would need to take account of firm, industry and country specific factors apart from the issue of the multinational nature of firms (see for example, Kumar, 1990; Willmore, 1992).

1.3 Empirical Studies on Capital Inflows and Inequality

There is a broad consensus that income inequality has risen in industrialised countries since 1980. The World Bank reports that there was a "serious ... increase in within country inequality in industrialised countries reversing the trend of the period 1950-80" (World Bank 2000a, 46). Similarly, Goattschalk and Smeeding (1997, 636) found that "almost all industrial economies experienced some increase in wage inequality among prime aged males" in the 1980s and early 1990s. Further data from the Luxembourg Income Study (LIS, 2000) show that, among 24 countries, 18 experienced increasing income inequality, five (Denmark, Luxembourg, the Netherlands, Spain and Switzerland) experienced decline in inequality, and one (France) saw no change.

Income inequality is also rising in industrializing countries. An unambiguous rise in inequality is recorded in Latin America in the 1980s and 1990s. (Lusting and Deutsche 1998; IADB 1999; UNCTAD 1997; ECLAC 1997). Other areas (For example South East Asian Economies) also saw inequality rise in the 1980s and 1990s (Faux and Mishal 2000; Ravallion and Chen 1997). Denninger and Square (1996) found rising inequality in East Asia, Eastern Europe

and Central Asia since 1981. Only Sub-Saharan Africa shows a trend towards more income inequality since the 1980s.

1.4 Empirical Studies on FDI and Technology Spillovers

Empirical attempts at measuring the technology spillovers of FDI fall into two groups. The first group of studies try to correlate the presence of foreign firms within a sector to the productivity of local firms in that sector. The second group used production functions to analyze spillovers, typically in a case study format. Overall, the empirical evidence suggests that sectors with higher levels of foreign involvement exhibit higher productivity or higher productivity growth, or both (Saggi, 2000). Of course, this does not necessarily mean that FDI causes an increase in productivity. In fact, as the FDI - growth relationship, one could argue that it is jut as likely that FDI is drawn to sectors that tend to have higher productivity levels in the first place.

Firm-level studies provide a better opportunity to assess whether FDI is having an effect on technology transfer and productivity at the micro level. In one of the first firm-level time-series studies to explore FDI spillovers, Haddad and Harrison (1993) utilize data from the Moroccan manufacturing sector for the period 1985 to 1989. They find that foreign firms have higher levels of total factor productivity but lower rates of productivity growth than domestic firms. However, they could not link productivity growth of domestic firms in specific sectors with foreign involvement in that

sector. They did not find any statistically significant evidence of technology spillover from FDI.

More contrary evidence to FDI's technology transfer capacity comes from a study by the Reserve Bank of India in 1996. Jha (1999) reports that FDI has not contributed significantly to India's technological capacity or export competitiveness. On the other hand, the study also states that positive contributions of FDI may include raising total factor productivity by creating a more competitive environment leading to technological upgrading, better management and other improvements in entire sectors. Of course, this highlights the complexity in determining the overall impacts of FDI within a country.

Some researchers argued that higher technology transfers and spillovers are possible when certain conditions are met. For example, Kokko (1994) analyzes FDI-related technology spillovers with a panel data set from the Mexican manufacturing industry and finds that spillovers are less likely to occur in industries where large technology gaps exist between MNCs and domestic firms. Presumably, the closer the level of technological capacity between the foreign and local firms, the more likely local firms can absorb new technologies. This is confirmed by de Mello (1997) who finds that productivity spillovers are least likely to occur when the technology gap is large, such as when foreign firms are concentrated in "export enclaves" with no significant linkages to the local economy and no competition. He also argues that higher levels of transfer and spillovers are possible when the level of education is higher in the host country,

when the competition with existing firms is greater, and when there are fewer legal and institutional barriers to operation. Industry-specific characteristics such as the degree of concentration appear to be more dominant than country-specific factors in determining technological transfer and the scope of productivity spillovers from FDI.

2. Kalecki's Theory on Foreign Capital and Economic Development

For any underdeveloped country, to develop more, import of machinery, technical know-how, spare parts and even raw materials is essential. One method to pay for import is to step up export. This is possible if government is prepared to curtail consumption and export more, simultaneously curtailing import of consumption goods (for example, Russia, China and others had adopted this method). The second alternative of getting foreign technology and equipment is to depend upon foreign capital or foreign aid. Various theories have been propounded explaining how foreign capital helps in economic development of the host country. one among them is by Kalecki which we will discuss in relation to, foreign capital and its impact of India's economic development in the dissertation.

Kalecki defines, foreign aid or capital or a may take three forms: grants, loans and foreign direct investment. The country receives foreign aid in terms of foreign currency, or its equivalent in goods, over the capacity to import generated by exports or financed from accumulated reserves, without the need of immediate payment

and at a cost lower than the prevailing rates of commercial loans. These additional resources are used to improve the recipient country's economic performance above the level otherwise attainable. He assumes, this higher rates of growth implies changes in the structure of the economy, and in the process many structural rigidities and imbalances emerge. Which gives rise to the scarcities in supply of goods and services but which can be relieved only by additional imports.

Kalecki in his theory has evaluated the role of the foreign aid in context of a comprehensive analysis of the development problems of the recipient country. he has examined closely the effects of foreign aid on balance of payment, trade, employment, political decision making, etc.

He further clarifies that with foreign aid, economic performance of the country will not improve if it leads to the import of 'luxuries' and, not the capital goods and basic goods. An inflow of foreign aid may be instrumental in stepping up the rate of growth of an economy faced by barriers of foreign trade. But such a result by no means follows automatically from the inflow of foreign aid which may be dissipated in additional consumption of 'luxuries'.

Additional imports, financed through and cause successive dislocations, step by step. And will be efficient to the extent to which it closes gaps between effective demand and supply in the process of development of the recipient country. and, aid can be sustained for long if its terms and conditions are favourable and

country is able to generate enough resources to finance the imports and partially, the debt.

Kalecki, from the purely economic point of view, prefers grants because it do not involve any interest payment and hence, does not pose any balance of payment problem to the recipient country. However, certain political problems arise when grants are tied with certain conditions. This may hamper the development process.

It is some times argued that direct foreign investment is cheaper to the recipient country than any credit because it needs not be repaid. But the profit transferred abroad may exceeds the cost of servicing a foreign loan. In regard to loans there are obligations for a number of years but in long run the impact of continuous foreign direct investment on the balance of payment of the recipient country must be negative, unless the inflows of foreign investment grows substantially from year to year. in order to make the inflow of foreign direct invesment useful, certain conditions should be enforced:

(a) Foreign private investment should be licensed from the point of view of branch allocation, localisation and concentration of foreign capital in different sectors of the recipient country's economy.

(b) Foreign owned enterprises should be submitted to the same taxation as local enterprises and their books audited by the officials of the recipient country's government, especially with the view of ascertaining whether the declared export pries are not too low and the declared import prices for materials and equipment are not too high.

(c) All payments abroad, including royalties, transfers of profits and repatriation of capital, should be limited and controlled.

(d) Reinvested profits should be treated as domestic private capital (e.g. the transfer both of these profits at any future date and also of the profits derived from their reinvestment should be prevented).

3. Various issues raised

- What kind of foreign investment inflows to India in the 1970s and the 1980s and what were its sources?
- Why, both the pattern and nature of foreign capital changed after the mid 1980s?
- What were the reasons that BOP crisis erupted in India in 1991?
- What have been the impacts of foreign capital on the economic development in India during the 1990s and 'how' and 'why' these are different from the effects in the seventies and the eighties?

In the light of the above discussion we divide this dissertation into six chapters. Chapter II deals with the nature, size of foreign investment and various policies towards it during the 70s and 80s. Chapter III elaborates on the nature of trade and foreign investment in the 1990s. Foreign capital and its impact on India's economic development is studied in Chapter IV. A comparative study of the role of foreign capital in India and China is undertaken in Chapter V. Finally chapter VI present the concluding remarks of the dissertation.

Chapter II

FOREIGN CAPITAL DURING 1970S AND 1980S: ITS SIZE, NATURE AND POLICY

Contents

Introduction

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Chapter II

Introduction

India adopted a mixed economic system in its post independence period where public and private sector were both given a strategic role and co-existence of market and state regulation was the central theme of the Indian planning system. Stringent controls on trade, for instance, import substitution, export pessimism, regulated capital inflows (almost negligible capital outflows), development of more public investment and lesser role to the private investments, were some of the main characteristics of Indian economy in the post independence era till mid 1960s. The year 1966 is considered as a benchmark year in the Indian economic history. This was the year when Indian economy faced balance of payment crisis and it was the time when India really understood the importance of foreign exchange reserves and hence the need to switch over to export promotion strategies from the hitherto export pessimism. Since then, there is no looking back on this front, however, more and more new developments have been introduced on this front overtime. Though current account of the balance of payment has witnessed remarkable change, the capital account exhibited more or less the same picture since independence uptill the beginning of liberalisation process in the early 80s. The chapter discusses the nature of the capital inflows, their size, its source, their sectoral distribution and government policies towards attracting more and more capital from abroad particularly, in 1970s and 1980s. The chapter goes like this. In

section A, various forms of capital inflows, its sources and its size is discussed. Section-B we talk about the various policies and the sectoral distribution of capital inflows Sections are respectively divided for 1970s and 1980s.

Section-A

Generally capital inflows into a country take various forms such as:

- Foreign Direct Investment (FDI)
- Portfolio Investment (PI)
- Grants and Aids from International Financial Institutions
- Commercial borrowing from abroad or ECBs/NRIs deposits

The size, composition and geographical distribution of external capital inflows to the developing countries have undergone fundamental shift during the past three decades. Until the early 1970s, the most important source of external financing for developing countries was official loans and aid. Foreign direct investment (FDI.) and portfolio investment (PI) to the developing countries were almost negligible and whatsoever of FDI. and PI was there, were among the developed countries (especially US and EU countries). The kind of capital inflows to the developing countries was based on certain provisions so that the developing countries suffered from resource gaps resulting from their low level of income and savings and their ability to fill these gaps through commercial borrowings at market terms was severely limited. Official Development Assistance (ODA) continued to expand

rapidly in the 1970s. However there was also a rapid expansion of private financial flows, primarily in the form of syndicated credits from banks in the OECD countries, which served to recycle the surplus of major oil exporters (UNCTAD, 1999). The expansion came to an end with the debt crisis of the early 1980s. The growth of the private capital inflows in the 1990s represents, to a great extent, a recovery from the depressed levels of the 1980s rather than a break from the past trends.

Net capital inflows into the developing countries have risen by more than 20 folds in nominal terms since 1970, reaching an estimated $ 225 billion in 1998. However in real terms, the increase is less impressive. If the import price index of developing countries is used to deflate these current values (i.e. to express them in terms of their purchasing power over foreign goods) the increase in net capital inflows is about five fold. At around 12 percent, the average annual growth of real flows is only moderately higher in the 1990s than in the inflationary years of the 1970s.

Capital inflows can be better assessed if expressed as a proportion of GNP of the recipient countries. On this measure (Table 1 and 2), the recent surge in inflows merely constitute a recovery from the stagnant level of 1980s. Instead, despite the much acclaimed absolute rise in capital inflows of developing countries in 1990s, they have averaged around 5 percent of GNP since the beginning of the decade, which was roughly the level prevailing before the crisis in early 1980s. There can be little doubt that in some respect capital inflows in 1970s were unsustainably high as they were encouraged by

a number of temporary factors such as oil price shocks of 1973-74 and 1978-79, negative real rate of interest and under assessment of sovereign risk (UNCTAD, 1999). However, it is not easy to judge to what extent recent flows to developing countries are more sustainable and more soundly based than those in 1970s. These overall trends have been associated with major shift in the composition of capital inflows. During the first half of 1970s net private and net official inflows were of roughly the same order. From 1976 onwards, private capital accounted for about two-third of the total net inflows. Although share of official flows fell, their contribution increased in terms of GNP of the recipient countries. This trend continued until the outbreak of crisis in the early 1980s, when the share of private inflows in total inflows fell as a result of reduced bank lending.

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There has been considerable changes in the composition of private capital inflows during the past three decades. From the mid 1970s, until the outbreak of debt crisis, bank loan constituted three quarter of total private net capital inflows of the developing countries, the rest consisting of FDI. This pattern changed drastically after the debt crisis, when bank loan collapsed and FDI predominated.

Finally these changes in the composition of net capital inflows have been accompanied by shifts in their distribution among developing countries and regions. In particular, official flows still favour poorer developing countries and regions. Thus the share of Sub-Saharan Africa and of South Asia, increased from 1975-83 to 1983-89, while that of Latin America declined sharply. Twenty developing countries, known as the emerging economies, received

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around 50 percent of the total net capital inflows of developing countries during 1970s and 1980s and their share rose to over 90 percent in the 1990s.

Now, from this detailed analysis of the nature, size, composition of capital inflows of the developing countries, the focus has been shifted to a country case study on all the above fronts of capital inflows.

2.1 Capital Inflows in India in 1970s and 1980s.

Since independence, Indian economy faced a number of crisis on balance of payment like in 1965-66, in 1973-74 and 1979-80. 1970s was the decade when Indian economy experienced many socio, economical and political problems. As explained above, the kind of capital inflows to the developing countries, grants and loans or other kinds of financial aid were dominating on the chart of capital inflows.

2.1.1 Foreign Aid to India.

In absolute terms India has been the biggest recipient of foreign aid for development purpose (Jalan, 1991). However its position is not enviable if we consider the amount of aid in relation to its population. During First Plan period, India received on an average an external assistance of Rs.40 crore per annum. This was certainly a modest amount by any standard. Thereafter, for more than a decade there was a steady increase in external assistance. During Third Plan period, India got on an average, external assistance of Rs.573.3 crore

per annum which was 3.2 percent of GDP. Thereafter, for three years the economy was in bad shape. Hence reliance on foreign aid increased during this period. The Fourth Plan marked a distinct change in the pattern of finance. This change was induced basically because of two reasons:

1. USA cut down aid to India drastically as the latter refused to fix its lines on a number of political issues.

2. Because of the increasing charges, the Government of India opted for a policy of increasing self reliance.

The Sixth Plan envisaged a net inflow of foreign resources of Rs.9929 crore (Rs.5889 crore as foreign aid and Rs.4040 crore as other inflows from abroad). The seventh plan envisaged net inflow of capital from abroad of Rs.18000 crore which was again 10 percent of public sector plan outlays of Rs.1,80,000 crore. The Eighth Plan reduced the contribution of net capital inflow from abroad to 6.0 percent The actual dependence on foreign aid was still at 5 percent in the Eighth plan. Table 3 gives details on the authorisation and utilisation of foreign aid in India. These datas show that utilisation of foreign aid in India has been considerably less than the authorisation. For instance, the total authorisation of foreign aid up to the end of Fourth Plan was Rs.13056 crore whereas utilisation was merely Rs.11,922 crore and this shortfall has been particularly marked during the period of the Sixth and Seventh Plan. Another important conclusion that emerged from the table is that the authorisation of foreign aid has increased considerably during the last decade and half.

2.1.2 Forms of Foreign Aid

India for quite a long time relied on foreign aid. India basically received three forms of foreign aid-loans, grants and PL 480/665. Assistance repayable in rupee or in any convertible currency is meant to help the country in meeting any shortage of resources in the development process. However if not used properly in the long period, it becomes a burden because of amortisation and interest payment which eat away an increasingly sizeable proportion of foreign earning. Grants carry no such burden of re-payment and are therefore is better on this front. A substantial part received under PL 480/665 from U.S.A. till 1967-68 was re-payable in rupees. However, after this year, U.S.A. expressed its willingness to grant assistance. Aid under PL 480\665 was completely stopped after 1977-78.

Details of foreign aid received under the above mentioned three forms are presented in Table 3. As shown in the table, total authorised foreign aid up to the end of Fourth Plan was Rs.13,055 crore of which the share of loans was Rs.9665 crore (i.e. 7.4 percent) and the share of grants was Rs.753 crore (i.e. 6 percent). The remaining Rs.2638 crore (i.e. 20 percent) was the share of assistance received under PL 480/665. Similarly during the Fifth Plan, total authorised foreign aid was Rs.9844 crore of which the share of loans was Rs.17.95 crore (i.e. 18 percent) and assistance under PL 480/665 was negligible. During the 6th plan the share of loans and grants comes out to be around 90 percent and 10 percent respectively. Whereas during the Seventh Plan the share of loans shoot up to Rs.93.6 percent.

2.1.3 Sources of Foreign Aid

Generally, main sources of foreign aid to developing countries are the developed countries, and international institutions like International Bank for Reconstruction and Development (IBRD), International Development Association (IDA), Asian Development Bank etc. Some aid have also been received from oil and petroleum exporting countries (known as OPEC, comprising Iran, Iraq, Kuwait, Abu Dhabi and Saudi Arabia). Sources of foreign aid to India is presented in Table 3.

It is amply clear from the table, a major part of foreign aid has been received by India from international financial institutions. The share of IBRD in authorised and utilised aid up to end March 1998 stands at 22.4 percent and 22.9 percent respectively (which is more than one-fifth of total aid). Whereas the share of IDA in authorised aid up to end March 1998 has been 20.84 (i.e. one-fifth) and in utilised aid 24.8 percent (i.e. about one fourth). In sum. IBRD, IDA and ADB accounted for as much as 51.9 percent (i.e. more than half) of the authorised aid and 55.2 percent of the utilised aid up to period specified above. When a country wise study is made, it is Japan which tops the list with its share in both authorised and utilised aid at 16.2 percent and 14.1 percent respectively up to end March 1998. The erstwhile USSR's share in authorised aid has been 7.8 percent but its share in utilised aid was only 2.1 percent whereas the share of West Germany was 5.4 percent and 6.3 percent respectively in authorised and utilised aid. Other important countries providing aid to India have been U.K. France and U.S.A. A study of the table also

reveals the fact that a substantial part of authorised aid was not utilised for instance, as against authorisation of Rs.40,842 crore worth of aid by World Bank upto end March 1998, utilisation stood at Rs.29,643 crore only. Similarly, Rs.5522 crore (i.e. 14 percent) aid authorised by IDA could not be utilised. Non-utilisation in case of ADB stood at Rs.6820 crore (i.e. 41 percent of aid authorised).

2.2 External Commercial Borrowings (ECB)

In order to tide over the problems of balance of payment, India had to rely heavily on external commercial borrowing and NR's deposit (Jalan, BOP from 1956 to 1991). As far as external borrowings are concerned, they were used extensively in latter half of eighties to finance the current account deficit. Thus was the period which ECB accounted for more than 25 percent of the capital inflows in India. In 1986-87, their share in total capital inflows was as high as half (i.e. 48.1 percent). India started initially with conventional syndicated loans managed by American, European, and Japanese banks & then started raising the funds in the international bond market. Financial institutions and public sector undertakings together accounted for about 90 percent of total approvals of ECBs.

ECB were modest before 1980-81. In 1980-81 they stood around at Rs.1038 crore. In fact over the entire period of Sixth Plan (1980-81 to 1984-85), approval of ECB stood at Rs.7259 crore. However a substantial amount of ECB as percentage of total capital inflows, was recorded in the Seventh Plan. Both authorisation and

disbursement were high at $ 10.8 billion and $ 10.48 billion respectively. However the net transfer comes to only $ 3.58 billion as a substantial amount was paid back in terms of debt service payments. Interest payment alone accounted for $ 3.49 billion. There was a steep decline in ECBs to India in 1990-91. According to Economic Survey 1991-92, the reasons for this decline were as follows:-

1. fall in the overall availability of international credit due to capital adequacy requirements of the banks for international settlement.

2. Gulf crisis which created an atmosphere of uncertainty in the international capital market.

3. The downgrading of India's credit rating for long term fund by international rating agencies.

Before we give a concluding remarks to this section, two more observations made by Bimal Jalan need to be pointed out - the first observation relates to the delays in implementing the large public sector projects and as a consequence of that debt servicing crisis. According to him, most long term loans have to be repaid in 5 to 8 years. Whereas the gestation period of most of the public sector projects is 4 to 5 years. In fact these projects are delayed further because of a number of reasons.

Jalan's second observation relates to the risk of depending too much on short term borrowings. During 1987-91, India borrowed Rs.

6000 to Rs. 7000 crore by way of short term loans (of a maturity of less than one year). This was in reaction to the accretion of Rs.10,000 crores of non residents foreign currency deposits (with maturity of less than three years or three years). These short term loans required continuous rerolling in order to reduce the burden of repayment. However, with the fall in India's credit rating the renewal of the short term loans became difficult.

2.3 Capital Inflows from Non-Resident Indians (NRIs)

For centuries Indians have been staying abroad, in all corners of the globe. Even today it is a continuous process that people from India are migrating abroad in search of better job avenues. Nayyer has pointed out clearly the cause, consequences and the nature of this migration. In his words "for India, the migration of its labour across national boundaries is nothing new. It began a long time ago. The contacts with Persian Gulf regions and South East Asia, in terms of both trade in goods and movements of people, goes back several centuries. The migration of workers on a significant scale came much later, to begin with in the colonial era and then in independent India".

The migration is both temporary and permanent which since independence has been associated with two sorts of financial flows, both of which have acquired significant dimensions since the mid 1970s. First, there are inflows of remittances that represent unrequited transfers from migrants to support their families whether for consumption or for investment. Second, there are capital inflows in the form of repatriable deposits. Here in this subsection, with the

available evidences will be discussed these two forms of NRIs capital inflows and examine the underlying factors.

2.4 Remittances

In balance of payment, remittances are identified as the credits on account of private transfer payments. These aggregates includes grants that constitute a very small proportion of the total. The trend in such private transfer payments, since 1970-71 are shown in column of table below (Table-4). As is clear from the table that the growth was impressive in the beginning of 1970s, though slowly but steadily remained constant till mid 1970s.

The Dollar Area comprises the U.S.A., Canada, the Central American countries and a few countries in Latin America. The region of the OECD area in India's BOP statistics is constituted by countries of Western Europe, excluding England and including Turkey.

Hence it would be reasonable to assume that private transfer payments from this region are attributed entirely to remittances from Western Europe. The sterling area comprises the commonwealth countries that were then a part of British Empire. Apart from U.K. and Ireland, the sterling area region includes the Carribean islands, some countries in East and West Africa (such as Kenya, Tanzania, Zambia, and Nigeria), the Persian Gulf states in the Middle East (Bahrain, Kuwait, Oman, Qatar, and UAE), South Asia (Pakistan, Bangladesh and Sri Lanka), parts of South-East Asia (including Hong Kong, Malaysia and Singapore), Australia, New Zealand, and Fiji. Given the diverge range of countries, the desegregation of private

transfer payments from the sterling area is a complex problem. The share of UK and Australia in private transfer payments from the sterling areas was 60 percent until 1973-74, 40 percent in 1974-75 and 25 percent in 1975-76 whereas the corresponding share of Persian Gulf States was 10 percent, 20 percent and 50 percent respectively. The remaining share of 30 percent, 40 percent and 25 percent respectively, was attributable to the East African and South East Asian countries in the sterling area. For the period 1976-77 to 1990-91, it is assumed that the share of the Persian Gulf State in private transfer payment from sterling areas was two-thirds. The region described The Rest of the Non-Sterling Area comprises the remaining countries of the world, including the socialist countries of Eastern Europe, most of Latin America and a very large part of Africa. It is a significant factor that a number of oil-exporting countries in West Asia and North Africa in particular, Saudi Arabia, Iran, Iraq and Libya, are parts of this region. Hence, unrequited transfer from the rest of the non-sterling areas are likely to be originating from the developing countries of Asia and Africa. These receipts were negligible until the mid 1970s, but increased at a phenominal pace thereafter and the share of the petroleum exporting countries of West Asia and North America in private transfer payment from this region was negligible until 1973-74, 50 percent during the period 1974-75 to 1975-76 and 90 percent during 1976-77 to 1984-5.

Table 4 outlines the trends in foreign exchange value of remittances in terms of U.S. Dollar and SDR. The latter is perhaps a better numeraire insofar as it represents the basket of currencies

(Nayyar 1994). The Table reveals that the dollar value of remittances registered a spectacular growth in the second half of the 1970s which was followed by stagnation and decline in the 1980s. Total remittances rose from US $ 0.5 billion in 1975-76 to $ 2.7 billion In 1980-81, stablised at a level of about $ 2.5 billion until 1984-85, fluctuated in the range of $2 billion to $2.7 billion but thereafter showed some evidences of decline towards the end of the 1980s. The stagnation in the dollar value of remittances after 1980-81 was, however, partly attributable to the sharp appreciation of the U.S. $ vis-à-vis the rupee until 1984-85 which slowed down in the subsequent years.

The trend and nature of such remittances into India from abroad should be looked at in a longer term perspective. It needs to be recognized that remittances from Indian overseas are not an entirely non-phenomena and were significant even on the early 1950s. They were larger than the aid inflows and sufficient to finance two-fifth of the trade deficit at that time (Nayyar 1982). The limited evidences that are available suggest that remittances per capita from the migrant population on the industrialized countries was much more lower than the level of per capita from the migrant population in the Middle East.

Following are the factors which explain why remittances since 1970, as part of private financial transfer from abroad, constituted a significant proportion.

(a) In June 1972, rupee was pegged to the pound sterling and floated. There was also a steady depreciation in exchange value of rupee via-a-vis the SDR basket of currencies. The over valuation of the rupee which had persisted for more than two decades, almost disappeared so that by late 1975 the market and official exchange rate nearly coincided. This eliminated the primary incentive for remittances through unofficial exchange broker and probably reduced the supply of foreign exchange through illicit channel.

(b) During this period, government policies also arrived at a judicious blend of carrot and stick which facilitated the increase in remittances. On the one hand there was a simplification of banking procedures for remittances, an extension of banking services overseas, and liberalization of foreign exchange regulation for NRIs. On the other hand, the government began to enforce the laws against smuggling in a concentrated drive during the period 1975-77. This combination of policies, enhanced the inflow of remittances through official channels.

There was stagnation and decline in dollar value of total remittances during 1980s. It is also clear that the drop in oil prices and the consequent economic slow down in mid 1980s, squeezed the labour outflow to, and remittances from, that region. In second half of the 1980s, therefore the foreign exchange value of remittances from Middle East, in terms of both U.S. Dollar and SDR registered a decline.

2.5 Capital Flows :

Repatriable capital inflows, associated with labour migration from India, are somewhat a different phenomenon. Unlike remittances, inflows that represent unrequited transfers in current account of the balance of payment, capital inflows which originate from NRIs on the form of deposits, are repatriable. These are entered into the capital account of the BOP. In the early 1970s (1972), the government introduced a facility which allowed NRIs and persons of Indian origin abroad to open and maintain external rupee account. In 1975, this facility was enhanced to allow foreign currency from non residents which could be denominated either in US dollar or in pound sterling. In 1988, the facility was extended further to accounts denominated in Deutche Marks or Japanese Yen. The balance on these accounts, as also the interests earned thereon, are repatriable. While depositors who hold their money in external rupee accounts carry an exchange rate risk, the depositions the foreign currency denominated external accounts are free from any exchange rate risk, as the money can be repatriated in the currency in which they were denominated at the time of deposits.

The rupee value of outstanding deposits and net inflows in external accounts maintained in India by NRI or migrants of Indian origin for the period from the mid 1970s are shown in Table.

As shown in the table, in terms of rupee value at current exchange rate, there was a phenomenal increase in the total outstanding deposits in external accounts, which rose from Rs.0.7

billion at the end of 1975-76 to Rs.217 billion at the end of 1991-92. This increase was interrupted but remained uneven over time. Much of it was concentrated in the second half of 1980s. This is reflected in the fact that the rupee value of outstanding deposit jumped from Rs.56.5 billion in 1985-86 to Rs.178.3 billion.

The trends in the aggregate do not show the significant changes in the composition of the stocks and the flows in these external accounts during the 1980s. Until the early 1980s, net capital inflows were confined largely to the non-resident external rupee account, whereas the net capital inflows into the foreign currencies non-residents accounts were small, and in some years even negative. Beginning in 1982-83, however, there was a rapid change in the composition of these capital inflows. The share of foreign currency non resident accounts in the total inflows rose from a negligible level in 1981-82 to an average level of 36.3 percent during the period of 1982-83 to 1984-85, and an average level of 81.8 percent during the period of 1985-86 to 1989-90.

Table 5 gives a complete picture on the separate magnitude of the capital inflows and capital outflows associated with such repatriable deposits. For this purpose the table represents the evidence on private long term capital inflows in India's balance of payments. From the table it is clear that total net inflows into external account were 16.5 per cent of the total remittances during the period of 1975-76 to 1979-80. This proportion increased to 19.2 per cent during the period of 1980-81 to 1984-85, and jumped to 58.5

during the period 1985-86 to 1989-90. It is not surprising that this proportion fell to 11.2 per cent in 1990-91.

SECTION – B

In Section A, we talked about the size, trend and direction of foreign capital inflows to the developing countries and more importantly the emerging market economies mostly in Asia and Latin America. A detailed analysis was also made about the various forms of capital inflows to the developing countries and more importantly the emerging market economies mostly in Asia and Latin America. Further an analysis was also made about the various forms of capital inflows in India in post independence era of 1970s and 1980s. In this section we will take up this ongoing discussion on foreign capital inflows further to various polcies that Indian economy adopted in order to attract more and more foreign capital to tide over any difficulties in balance of payment. As we have seen above in Section A, quite a major portion of total financial assistance from international financial institutions (viz. World Bank, ADB, etc.) was conditional change concessional i.e. their sectoral distribution should be such that development process is carried further.

2.6 Government Policy Towards Foreign Capital

During the time of indepedence, the attitude towards foreign capital was fearful and suspicious given the bad history of colonolisation of Indian economy by Britishers which had led to large scale drain of wealth from India. This suspicion and hostility towards foreign capital found

expression in the Industrial Policy Resolution (IPR) 1948 which though recognised the role of foreign capital in the country but emphasised that its regulation was necessary in national interest. Because of this attitude of I.P.R. 1948 foreign capitalist got dissatisfied and as a result, the flow of the import of capital goods got obstructed. Thus in order to come out of this problem, the former Prime Minister gave the following set of policies:-

1. No Discrimination between foreign and Indian capital - the Government of India will not differentiatie between foreign and Indian capital i.e. the Government would not impose any restriction or condition on foreign capital if they are not applicable to private Indian capital.

2. Foreign Exchange position permitting, reasonable facilities would be given to foreign investors for remittances of profits and repatriation of capital.

3. Guarantee of compensation - In case of nationalisation of the undertaking fair and equitable compensation would be paid to foreign investors.

From the available literature on Indian economy about the role of foreign capital, it can simply be concluded that I.P.R. 1948 and I.P.R. 1956 as well as Mr. Nehru's statement on foreign capital constituted the basis of Government policy on foreign capital till 1991 when New Industrial policy was announced.

The foreign capital was allowed with the expectation that it will supplement to domestic capital and scientific know how and technical assistance would be available. As matter of policy framework, ownership and effective control was in Indian hands. However, in a few cases, foreign capital was given a majority control of enterprises. The Government extended a number of tax concessions favouring foreign enterprises and streamlined industrial licensing procedures to avoid any delays in foreign collaboration. The Government of India in 1972 decided to permit wholly owned subsidiaries of foreign companies provided they undertake to export 100 percent of their output. However, in case the venture is to export less than 100 percent of its output, the extent of permissible foreign capital participation would be subject to negotiation with the government. During February 1972 the Government developed a precise formula setting out the limits of participation by Indian in foreign firms if they undertook plans of output expansion. Thus companies with foreign holding exceeding 15 percent would have to raise 40 percent of the estimated cost by issue of additional equity to the Indians. The corresponding proportion for companies with 60-70 percent foreign ownership would be 33.3 percent and for those with 51-60 percent foreign ownership would be 25 percent

Thus the Government of India's policy proposal for permitting foreign capital was based on its twin objectives – Indianisation of foreign subsidiaries and to boost up exports. Whereas the Janta party in its statement on Economic Policy in November 1977 laid the following guidelines regarding foreign collaboration

"The Janta Party will not go for foreign collaboration in areas where adequate Indian skills and capital are available. Whenever the need for foreign collaboration is felt in areas of high priorities, emphasis should be on purchasing outright technical knowhow, technical machinery and skills"

"the provision of FERA must be rigorously enforced in sectors of consumer goods industries. The foreign firms should be asked to carry forward the process of Indianisation".

During two years of Janta Rule, two major decisions regarding multinationals were taken and much advertised. Firstly coca cola company was asked to wind up its business. Secondly the Government asked IBM (International Business Machine) to dilute its equity to 40 percent so as to confirm with FERA guidelines. Since IBM did not agree, it was also asked to fold up its operation.

Despite these two decisions, MNCs continued to operate in non priority areas like tobacco, toiletries, beverages etc. For instance Hindustan Level was permitted 51 percent of foreign equity on the ground of introduction of sophisticated technology in India. But the permission was unwarranted because the products of Hindustan Lever include vanaspati, shampoos, toothpastes, soap, detergent etc. India can certainly produce these products and induction of sophisticated technology is a lame excuse. Even against the guidelines of FERA, several foreign companies viz. Alkali Chemicals, Indian Explosives, Dunlop, Good Years, Asbestos cement, Hindustan

Pickington, were permitted to retain foreign equity at 51 percent or more.

2.7 Purpose-wise Distribution of Capital Inflows

Up to the end of Fifth Plan, industrial sector (excluding steel and steel projects, and iron ore projects) accounted for 46 percent of the authorised aid and 53 percent of the utilised aid. If steel and steel projects and iron ore projects are also included, the share of industry in total foreign aid authorised and utilised goes up to 53 percent and 61 percent respectively. This shows that up to the end of Fifth plan, industrial sector accounted for more than half of foreign aid authorised and 60 percent of aid utilised. The share of agriculture sector in foreign aid authorised and utilised upto the end of Fifth Plan stood at 19 percent and 14.7 percent respectively. The share of transport and telecommunication in total aid authorised and utilised up to the end of Fifth Plan stood at almost 10 percent Power accounted for 8.5 per cent of total foreign aid authorised and 5.4 percent of total foreign aid utilised up to the end of Fifth Plan. The share of different sectors in foreign aid authorised during Sixth Plan stood as follows:- industry (including steel and steel project) 19.5 percent, agriculture 26 percent, transport and telecommunication 12 percent and power projects 32 percent The share of different sectors in foreign aid utilised during sixth plan is an under: Industry (including steel and steel projects) 38 percent, and agriculture 27 percent transport and telecommunication 39 percent and power projects 27.3 percent Details regarding authorisation and utilisation of foreign aid to different sectors of the economy in period after Sixth

Plan are presented in Table 6. As is clear from the table, maximum foreign aid has been received for the energy sector during the period 1985-90. During the Seventh Plan period, 41 percent and 31 percent of the authorised aid and the utilised aid respectively is used for the development of the energy sector alone. This is quite natural given the serious energy crisis since long. It is also clear from the table that more than one third of aid utilised in the Seventh Plan and 31 percent during the period 1985-98 has gone for the development of power sectors. The share of agriculture sector, during the Seventh Plan in aid authorised and utilised was 81 percent and 23.6 percent respectively.

During the Seventh Plan (1985-86 to 1989-90), energy sector was given the highest priority in the utilisation of foreign loans/credits accounting for nearly 35 percent of the total. Next in importance was agriculture, water management and fertiliser combinedly accounting for 23.6 per cent and industry 13 percent, social sector 6.3 percent and urban development 2.6 percent

Loans are meant to help the economy in meeting any shortage of resources in the development process. However if not used properly, in the long period they become burden because of amortization and interest payment which eat away quite a sizeable portion of foreign exchange earning. However, grants carry no such burden of repayment and thus are better.

Evidences are there that India in order to tide over the balance of payment relied heavily on external borrowing and NRI's deposits.

Conclusion

Evidences are there that India in order to tide over the balance of payment relied heavily on external borrowing and NRI's deposits. ECB were used extensively towards the second half of 1980s and this trend continued even during 1990s. It is observed by many economists including Jalan, that in order to make better and proper utilisation of ECB we not only have to remove the delays in implementation of large projects but also to curtail our dependency on foreign capital inflows especially short term which are largelly linked to the "herd instinct".

TABLE-I

Developing Countries: Aggregate Net Inflows By Type of Inflows Between 1975 to 1998.

(Percentage of GNP)

FLOW	**1975-1982**	**1983-1989**	**1990-1998**
Total Net Inflow			
Including China	4.91	2.87	5.00
Excluding China	5.45	2.97	4.87
Official Inflows	1.58	1.57	1.03
ODA Grants	0.53	0.62	0.56
Other official	1.05	0.96	0.47
Private Inflows	3.33	1.29	3.97
Non Debt Creating Inflows	0.42	0.55	2.21
F.D.I.	0.42	0.53	1.67
Portfolio equity	0.00	0.02	0.54
Bonds	0.11	0.05	0.52
Bank Credit	2.46	0.44	1.67
Short Term	1.10	1.10	0.72
Long Term	1.36	0.34	0.44
Interest Payment	1.49	2.58	1.79
Profit Remmittances	0.93	0.54	0.56

Source : UNCTAD Secretarial calculations, based on World Bank, Global Development Finance, 1999 (CD-ROM).

TABLE 2

Net Capital Inflows, Current Account Financing and Offsetting Financial Transaction in Developing & 16 Emerging Market – Countries.

(Credit in Rs. Crore)

	All Developing Countries			Emerging Market Countries	
	1990-94	1995-98	1990-98	1980-89	1990-97
Net Capital Inflows	825.8	1064.9	1890.6	355.3	1083.8
Net Capital Outflow	-142.0	- 435.3	- 547.2	- 49.6	- 256.2
Net Capital flows	683	629.6	1313.4	305.7	827.6
BOP Errors & Omission	- 49.9	- 106.3	- 156.2	- 39.5	- 53.2
Change in Reserves	- 221.3	- 216.5	- 437.7	- 10.6	- 231.6
Current A/C Balance	- 412.7	- 306.8	- 719.5	- 255.6	- 542.1
	Percentage of Net Inflows				
Net Capital Outflow	17.2	40.9	30.5	14.0	23.6
BOP E&O	6.0	10.0	8.3	11.0	4.9
Change in Reserves	26.8	20.3	23.2	3.0	21.4
Current A/C Balance	50.0	28.8	38.0	71.9	50.1

Source: World Bank, Global Development Finance, 1999

CD-ROM: IMF, World Economic Outlook, October 1998, IMF, BOP Statistics various issues.

Table 3

Foreign Aid To India: Authorisation and Utilisation

(Credit in Rs. Crore)

	Up to the end of 4th Plan	Fifth Plan 1974-75 to 1978-79	1979-80	Sixth Plan 1980-81 to 1984-85	Seventh Plan 1985-86 to 1989-90	1990-91 to 1998-99
AUTHORISATION	13,056	9,844	1,893	16,761	44,971	1,17,220
UTILISATION	11,922	7,259	1,353	10,904	22,700	99,948

Source : Government of India, Economic Survey 1991-92

Part-II, Statement 8.1 P.S. 93 and the Economic Survey 1999-00

Table 4

Trends in Foreign Exchange Value of Remittances To India

	Total Remittances		Remittances from the Middle East	
	US$ Million	SDR Million	US$ Million	SDR Million
1972-73	134	124	6	5
1973-74	184	150	9	8
1974-75	277	228	33	27
1975-76	490	409	152	127
1976-77	698	603	303	261
1977-78	1071	903	569	479
1978-79	1151	905	587	461
1979-80	1871	1397	976	750
1980-81	2692	2093	1542	1198
1981-82	2322	2015	1224	1062
1982-83	2514	2310	1418	1298
1983-84	2561	2421	1451	1371
1984-85	2508	2499	1442	1436
1985-86	2219	2101	1135	1074
1986-87	2340	1936	1203	995
1987-88	2725	2063	1393	1055
1988-89	2669	2007	1068	803
1989-90	2297	1790	1066	831
1990-91	2021	1459	808	583

Source:- Reserve Bank of India, Report on Currency and Finance, Annual Issue, 1992-93

Table 5

External Accounts Maintained in India by Non Resident Indians: Deposits and Inflows

(Credit in Rs Crore)

	Amount Outstanding at the end of Year			Inflows During the Years		
	1	2				
	Non Resident External Rupee Accounts	**Foreign currency Non Residential Account**	**Total Deposit**	**Non Resident External Rupee Accounts**	**Foreign currency Non Residential Account**	**Total Deposit**
1975-76	639	75	714	294	75	369
1976-77	1894	570	2464	1165	495	1660
1977-78	3247	1424	4671	1170	854	2024
1978-79	4919	1568	6487	1398	144	1542
1979-80	7009	1538	10900	1658	- 30	1628
1980-81	9377	1523	14057	1820	- 40	1780
1981-82	12950	1467	19306	2220	- 160	2060
1982-83	16792	2514	28691	2740	1090	3830
1983-84	22543	6148	38190	3780	3310	7090
1984-85	28640	9550	56500	6040	2750	8790
1985-86	36610	21890	78472	6160	11510	17670
1986-87	43362	35110	100540	4770	11730	16500
1987-88	51070	49470	141540	4770	13630	18400
1988-89	58900	82550	178310	2350	22300	24650
1989-90	65070	113240	207540	- 40	21790	21750
1990-91	73490	134050	216790	1560	2550	4110
1991-92	80710	136080	217710	- 440	- 36410	- 36850

Sources: For the period 1984-85 to 1991-92 RBI Annual Reports 1988-90 onward for the period 1980-81 to 1983-84 for data on accounts outstanding at the end of one and for dates on inflows unpublished RBI estimates.

1. Include accrued rate of interest.
2. Do not include interests.

Table 6

Private Transfer Payment in India's Balance of Payment by Region

(Credit in Rs. Million)

Years	Sterling Area	Dollar Area	OECD Area	Rest of Sterling	Total
1970-71	372	843	114	35	1364
1971-72	579	939	194	33	1745
1972-73	459	1003	159	32	1653
1973-74	736	1041	189	67	2033
1974-75	1107	1267	349	76	2799
1975-76	2481	2280	502	149	5412
1976-77	3541	2871	664	380	7457
1977-78	6157	2502	786	848	10293
1978-79	6075	2720	949	848	10592
1979-80	9783	3809	1192	1532	16320
1980-81	15283	3490	1684	2297	22687
1981-82	13168	4896	1866	2440	22370
1982-83	14961	4465	1828	4149	25410
1983-84	14957	5239	2119	5735	27850
1984-85	15297	5932	2220	7713	31162
1985-86	14507	6002	2578	5266	28354
1986-87	16539	5323	2617	5427	29906
1987-88	16830	6245	3705	8547	35323
1988-89	14563	12955	3943	7193	38654
1989-90	15696	7998	5434	9111	38239
1990-91	16899	8645	4633	6083	36260

Source: Reserve Bank of India, Reports on Currency and Finance, 1992-93.

Table 7

Private Long Term Capital Flows In India's Balance of Payment

(Credit in Rs. Million)

Years	Credits	Debits	Net
1980-81	2187	1416	+ 771
1981-82	2920	1736	+ 1184
1982-83	4426	2345	+ 2081
1983-84	9624	2657	+ 6967
1984-85	14667	3740	+ 10927
1985-86	26113	5190	+ 20923
1986-87	32184	9609	22575
1987-88	39556	17173	22383
1988-89	65976	33537	32439
1989-90	100696	68594	32098

Source: Reserve Bank of India, Report on Currency and Finance, Annual Issue, 1992-93

Table 8

Inflows of External Assistance in India During 1970s.

Rupees in Crore

	Authorisation	Gross Disbursement	of which Debt Relief	Debt Servicing	Net Inflows of Assistance
1970-71	762	791	77	450	341
1971-72	929	834	61	479	355
1972-73	672	666	106	507	159
1973-74	1171	1036	117	596	440
1974-75	1671	1314	116	626	688
1975-76	2654	1841	133	687	1154
1976-77	1285	1599	102	755	844
1977-78	1897	1290	28	821	469
1978-79	2334	1266	7	882	384
1979-80	1860	1367	11	884	483
1980-81	2507	2341	16	882	1459

Source : Govt. of India: Economic Survey, 1980-81 Page –54

Table 9

Inflow of External Assistance: In India During 1980s

Rupees in Crore

	1	2	3	4
Years	**Authorisation**	**Gross Disbursement of which : Debt Relief**	**Debt Servicing Including Interest Payment**	**Net Inflow of Assistance**
1980-81	3840	2165	868	1297
1981-82	2843	1968	912	1056
1982-83	3369	2145	953	1192
1984-85	4880	2354	1176	1178
1985-86	5650	2938	1367	1571
1986-87	6160	3596	2029	1567
1987-88	9040	5032	2623	2409
1988-89	13200	5291	2946	2345
1989-90	6255	5869	3460	2409

Source: Government of India, Economic Survey 1989-90, Page – 127

Chapter III

CAPITAL INFLOWS IN INDIA IN 1990S: ITS SIZE, EXPANSION AND POLICY FRAMEWORK

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Chapter III

Introduction

In the first half of 1991-92, India faced a severe balance of payment crisis. India was under pressure to adopt extensive liberalisation of trade and foreign capital. To tackle imbalanced and accelerate the rate of economic growth, the Government launched a major programme of economic stabilisation and structural reforms in July 1991. The programme was aimed at cutting fiscal deficit, reducing growth of money supply, allowing greater play for market force in resource allocation in both domestic and external and switching from official borrowing to unofficial borrowing (FDI, PI, NRIs deposits, etc.). India began to adopt a more extensive liberalisation policy towards FDI. The Statement of Industrial policy (SIP) 1991 stated that "Direct Foreign Investment has always been preferred to loans and advances and other form of assistance."

In order to make the economy competitive and fundamentally strong, as part of the reform packages announced in July 1991, following incentives have been announced in order to attract foreign investment in requisite amount and in desired sectors: Foreign Investment (FDI) limit was raised in a large number of industries, new areas were introduced for foreign investment, rules and regulation were liberalized to ease the entry of foreign investment portfolio investment was introduced, trade was liberalized new

Exchange Rate Policy was introduced in 1993 and last but not the least, financial sector was liberalized.

In 1996, the newly elected United Front Government of India in its Common Minimum Programme (CMP) announced its commitment to attract at least $10 billion a year of FDI. This FDI was not only looked as a source of funds but also to improve technology and management. This process of reform to has been continued by the present government. In its first budget, it committed itself to doubling the inflow of FDI within the next two years and to provide for faster clearance procedures. In the light of above discussion certain questions crop up. These are, how far the economy has been successful in attracting foreign investment of sufficient size and in desired sectors; and if not, then what are the factors behind this failure? What should be done to correct it?

In order to answer the questions raised above, the discussion in the chapter goes the following way. 1990s is a decade of the accelerating globalisation. Globalisation as a new phenomenon is described in section 3.1 Section 3.2 gives the detail of capital inflows to the developing countries. Various emerging issues and policy perspectives are elaborated in Section 3.2 Section 3.3 deals with the size, nature and policy framework during 1990s, in India. Finally section 6 ends with conclusion.

3.1 Globalisation : A New Phenomenon

Globalisation can be described as the process which involves growing economic interdependence of countries worldwide. though there is

no universally accepted definition of globalisation, different economists define it differently, but most of them agree that it is not a new concept. Under globalisation there is nothing like home or foreign market – there is only one market, the global market. Globalisation is a vast and complex issue since it involves both time and space (Kumar, 2002). In fact the present phase of globalisation, is in many ways, similar to the process of economic integration among nations, which began in 1750s and ended with WW1. However, there is a view that what has happen in India since 1991. Can only be understood as one link in a chain stratching back to 250 years. This entire period is characterised by a one-way globalisation as opposed to the earlier period when there was a two way process (Kumar, 2002).

The present globalisation process is characterised by five major developments:

a) rapid growth in international financial transactions

b) fast growth in trade, especially among TNCs.

c) Surge in foreign direct investment, largely contributed by TNCs

d) Emergence of global markets and

e) Diffusion of technologies and ideas through rapid expansion of a globalised transportation and communication system.

The gathering momentum of globalisation has already brought about profound changes in the world economy. It is worth highlighting the broad contours of these changes. An increasing

proportion of world output is entering into world trade, while an increasing proportion of world trade is made up of intra-firm trade. The growth in international finance has been explosive. So much so, that in terms of magnitude, trade and investment are now drafted by finance. The expansion of international banking is phenomenal. Between 1980 and 1981, net international bank loans increased from 51 percent to 131.54 percent of gross fixed domestic capital formation in the world economy. The international market for financial assets has experienced a similar growth.

In the earlier phase (the colonial phase) of globalisation, some of the most open economies, such as India, China, and Indonesia, experienced de-industrialisation and under - development. The process of globalisation then (1870-1914) was uneven. It is so even now. There are less than a dozen developing countries which are an integral part of globalisation in the late twentieth century: Argentina, Brazil, Mexico in Latin America and Korea, Hongkong, Taiwan, Singapore, China, Indonesia, Malaysia and Thailand in Asia. It would seen that globalisation is most uneven in its spread. And there is an exclusion in this process. Sub-Sahara Africa, West Asia Central and South Asian Countries are simply not in the picture. Hence, as many economists have predicted, globalisation will lead to uneven development in the years to come just as it did in the late nineteenth century.

The rules of the game for the international trading and investment system are being progressively set by WTO (World Trade Organisation), World Bank and International Monetary Fund (IMF).

But these are promoting one way globalisation (Kumar, 2002) which follows that the developing countries would provide access to their market without a corresponding access to technology and would accept capital mobility (say Capital Account Convertibility) without a corresponding provision for labour mobility. These new rules, which serve the interest of transnational corporation as capital exporter and technology lender in the world economy, are explicit as an integral part of a multilateral regime of discipline.

3.2 Capital Inflows To The Developing Countries: Emerging Issues And The Policy Perspective

The size, composition and geographical distribution of external capital flows to the developing countries have undergone a fundamental changes during the past three decades. Until the early 1970s the most important source of external financing for developing countries were official loans and aids and the provision of which was based on the thesis that developing countries suffered from resource gaps resulting from their low level of income and savings and their ability to fill this gap through commercial borrowing at market terms was severally limited. (UNCTAD, 1999).

The expansion came to an end with the debt crisis of 1980s, when total net capital inflows to developing countries fell sharply because of a cut back in commercial banking lending and stagnated at this level during the rest of the decade. Official inflows also stagnated, while its terms and conditions became more stringent, reflecting the policy of the major creditor countries and the

multilateral financing institution, emphasizing private financing for development. The 1990s have indeed witnessed a rapid expansion of private capital inflows, while official financing, notably, ODA, declined. This surge in private inflows was greatly influenced by rapid liberalisation of market and privatisation of economic activities in most developing countries.

In contrast to the earlier decades, the private sector has become the principle borrower in international market as most developing countries have relaxed control over such borrowings. An important proportion of private inflows however, has taken the form of the so called non debt creating inflows notably FDI.

A close examination of the recent trends in the net capital inflows to developing countries, however draws a less favourable picture, as summed up in the following points.

1. The growth with the capital inflows in the 1990s represents to a large extent, a recovery from the depressed levels of 1980s rather than a break in the past trend. Further more the, among the developing countries, the emerging economies have been able to attract the maximum amount of capital inflows.

2. An increasing proportion of private capital inflows have been offset by short term capital inflows or they have been devoted to costly reserve accumulation to safeguard against instability of capital inflows and speculative attack on currency rather than to finance current account deficit (CAD). Both these phenomenon

are closely linked to capital account convertibility in the developing countries.

3. Rapid and unchecked capital inflows breed instability in the financial markets which in turn, quite often, leads to political turmoil in developing countries.

Since the beginning of 1990s a number of emerging market have experienced booms & bursts in private capital inflows which were followed by equally sharp reversals of these flows, triggering currency and financial crisis. (Mexico, 1994, East Asian Economies in 1997 and Argentina, 2002). Thus an important part of the capital inflows constitute an unreliable source of development finance.

4. FDI flows to the developing countries are increasingly being linked to mergers and acquisitions. (UNCTAD, 2000).

Evidence thus suggests that there are serious shortcomings regarding the size, stability and sustainability of capital inflows to developing countries or they are of a one-off nature.

Net capital inflows into developing countries have risen more than ten fold in nominal terms since 1970 reaching an estimated $ 255 billion in 1998. However in real terms, the increase is less impressive. If the import price index of developing countries is used to deflate these current values (i.e. to express than in terms of their purchasing power over foreign goods) the increase in net capital inflows is about five fold. At around 12 percent, the average annual growth of real flows is only moderately higher in the 1990s than in the inflationary years of 1970s (UNCTAD, 1999).

Capital inflows can be better assessed if impressed as a proportion of GNP of the recipient countries. In Table 1, it is quite apparent that capital inflows to the developing countries during 1990s has averaged around 5 percent of GNP, which was roughly the level prevailing before the outbreak of the debt crisis of the 1980s. Quite surprisingly if China is excluded, the ratio 1990-1998 was more than one point lower than during 1970-1982 (Table 1).

As we have seen above, a fundamental change in the size, composition and geographical distribution of private capital inflows to the developing countries. It is being recorded that twenty countries among the developing countries, received 50 percent of the total net inflows during 1970s and 1980s and their share rose to over 90 percent in 1990s. These 28 countries are more or less concentrate in Latin America and Asia (Eastern and South Eastern) consisting : Singapore, Hong Kong, Indonesia, Malaysia, Thailand, China, in Asian region and Brazil, Mexico, Argentina, Chile etc. in Latin American region. Until 1997 crisis, in S.E. Asian economies, there was a continuous rise in inflows of capital (both FDI and portfolio investment). Following this, capital inflows to developing and transition economy increased to $ 199 billion in 2000 from a level of $ 151 billion in year back (UNCTAD, 2000) these are the countries undertook major policy change in both the external and external sectors, following a congenial and stable macro economic environment.

3.2.1 Emerging Issues

In the wake of recent developments on the balance of payment front of the developing countries especially the emerging economies, so many so, economical and political issues are emerging. A few of them are listed below :-

- Whatever capital inflows supplement domestic saving or not
- Impact of capital inflow on growth (i.e. GDP)
- Capital inflow and technology transfer
- Capital inflow and its impact on poverty & unemployment, and
- Learning from the crisis in the emerging economies, should developing countries go for capital account convertibility.

Capital inflows in any country supplement domestic saving if foreign investment is coming in new areas, generating new productive capacity and above all no mergers & acquisition. But the recent trend of capital inflows depict the same story that most of the capital flows in the developing countries is of the nature of mergers & acquisitions (M&A). Hence, whether capital inflow supplements domestic savings is a debatable issue. We will take up this issue in greater details in the forthcoming Chapters. There are lot of Literature available on how does capital inflow generate more economic growth. The whole literature we can divided between two groups, one which shows the positive relationship between capital inflows and economic growth and the other which do not support

this positive relationship. However these empirical studies are incomplete in themselves, the kind of assumptions they are based on, the kind of techniques they adopts etc are really questionable. We will take up all these issues in the Chapters to come, making a detailed analysis of the theme. From, along with World Bank, IMF and WTO, are of the opinion that capital inflows has a trickle down effect on poverty and unemployment in the developing countries. In order to support this logic they cite example of 'emerging economies'. Though a majority of these economies later experienced balance of payment and financial crisis. Furthermore, it is interesting to notice that these international financial institutions (WB IMF & WTO) are further favouring liberalisation and globalisation of trade and capital and holding the macro-economic policy responsible for recent crisis in the developing countries. And as a results of all these, majority of developing countries are coming in solid grip of this new economic order of international trade & capital.

3.2.2. Policy Factors:

1. Private Sector Developments

From the late 1980s and 1990s, it is increasingly recognised that market based economy is getting an edge over the State based economy and in the process private sector is being developed which also reflect the change in the government attitude towards attracting more and more FDI. (For example in Chile and Maxico) the emergence of private domestic suppliers and distributors network

comprising private domestic firms can give an additional impetus FDI flows to the developing countries.

Macro Economic Reform

In order to attract more and more capital inflows, developing countries have to resort to macro economic policies – low inflation rate, low current account deficit, high rate of interest (at least higher than LIBOR), flexible exchange rate. All these help in sustaining higher capital inflow.

2. Liberalisation

The initial jump in FDI flows is associated with the opening up of the countries to the rest of the world, particularly in trade & investment as TNC seeks to exploit first mover advantage which typically followed by additional investment. This liberalisation is expected to be not only in the origin & form of capital inflows, but also in its sectoral distribution. The deepening of the equity or stock market in developing countries can help in sustaining FDI flows by providing an additional source of finance to foreign officiates and allow TNCs to acquire domination firms listed in these markets.

3. Regional Integerations

To the extent that developing countries expand their economic boundaries through participation in regional integration schemes, either among themselves (e.g. moreover ASEAN, the Andean Group) or with developing countries (e.g. NAFTA, APEC, EU); they can create large market, and improve groups prospects. Regional integration

schemes can trigger intra-regional investment, as well as third country investment, as the experience of NAFTA has indicated and thus help sustain FDI into the participant developing countries.

3.3 Capital Flows In India : Its Expansion, Nature & Policy Framework During Post Reform Period

The Indian government attitude towards foreign capital has evolved over the post independence period in certain distinct phases. In the previous Chapter, giving a reference to pre-independence period type and nature of the capital inflows to India and taking 1960s as the base of decade of analytical comparison, an attempt is made to give a detailed analysis of capital inflows during 1970s and 1980s, there. Whereas in this Chapter decade of 1990s is taken up as period of reference. The reform started in 1991 aimed at making Indian economy an attractive resort of capital inflows along with the policies of liberalisation and globalisation making Indian industry more competitive at international front.

3.3.1 Factors that prompted capital flows

Capital inflows can be a response to external as well as internal factors, known as pull and push factors. The external or push factors are those which are unrelated to the policies followed by the recipient countries. A decline in available profit opportunity, low interest rates or the existence of necessary conditions can cause capital to move out of a country. In the beginning of 1990s, interest rates fell in OECD countries and lower the cost of capital for firms.

The reduction in rate of interests stimulated search by investors for new investments to help preserve yields. The increasing importance of portfolio investment reflected the expanding role of institutional investors such as mutual funds, insurance companies, pension funds and hedge funds, who became major purchasers of emerging markets equity and debt instruments.

There is a view that the initial private flows into these emerging economies causes a virtuous circle (Rangarajan, 1998). The initial inflows by investors led to easy liquidity conditions and increase in investment, which translated into higher growth. The international rating agencies (Moody, Standards & Poors, etc.) viewed this performance favourably and raised the ratings of these countries, which induced more flows by some major institutional investors regulated by minimum rating requirements for investments. In fact, this could have prompted herd behaviour among other institutional investors. However, such factors alone do not explain why capital flows taking place to one particular country or group of countries and not others.

The internal factors are those related to the stance of domestic policies. Successful price stabilisation and structural reform programmes (commonly known as Washington Consensus) and the consequent acceleration, or even the prospect of acceleration in growth, can attract capital from abroad. A tight monetary policy that keeps domestic interest rates high, coupled with exchange rate stability, may also generate capital inflows. Added to these are the bandwagon effects or herd mentality as explained earlier. The

growing importance of private flows reflect the trend towards liberalisation and globalisation of investment and finance. A number of developing countries removed or phased out barriers to current and capital transactions. Liberalisation of restriction on interest and dividend repatriation played an important role in attracting private foreign capital. Technological advancement (on account of indigenous R&D, FDI or import of capital) improved trading opportunity. Added to this developing countries made efforts to widen and deeper their market by introducing new instruments, allowing foreign participation in equity and bond markets, diversifying the currency denomination of bond issue and providing opportunity to hedge risk capital. Capital account convertibility has further speeden the movements and geographical distribution of FDI (Fadnavis, 1996). In his **Managing for the Future**, Drucker observes that "it is simply not possible to maintain substantial market standing it an important areas unless one has a physical presence as a producer. Otherwise one will lose soon lose the 'feel' of market." Trading is increasingly becoming dependent on investment as against the situation of investment following trade (Drucker, 1996).

3.3.2 FDI and Portfolio Investment : A Comparison

There are substantial difference between FDI and portfolio investment (PI). In case of FDI, investors exercise control over the management, while in case of PI, investors only provide financial assistance, and are not involved in management control. The investors are also different. In the case of Portfolio Investment, the investors base consists of institutional investors. For instance Merill

Lynch, Morgan Stanley and Fidelity are involved in Portfolio Investment. While investors involved in FDI are TNC such as Enron, Shell, Coke, Nestle, etc.

Usually, PI tend be of short term, ranging from a few weeks to a couple of years. Because of its highly volatile nature it is known as 'hot money' i.e. these investment can move out of the country as quickly as they come in. On the other hand, FDI tend to be long term in nature, as it involves capital equipment, factories, etc., which TNC can not easily liquidate. Otherwise, the 'sunk' cost will be too high.

Political stability is the single most important factor facilitating both FDI and Portfolio Investment. (Singh, 1993). However, investors of Portfolio Investment are only motivated by the financial return on their investment through capital gains and dividends. Therefore they attach more importance to high disclosure standards and easy repatriation of capital. On the other hand investors of FDI are more interested in size and growth of market, labour and productive costs and infrastructure.

3.3.3 Foreign Investment and Policies

As part of the economic reform various policies have been designed to ease the entry of foreign companies and to promote their share in the Indian companies. Various additional incentives have been provided to import capital and technology and to the NRIs and in all is created a congenial environment for FDI.

Diluting the provisions of FERA, the new policy removes the 40 percent ceiling fore foreign equity participation that existed during pre reform period and in many cases it provides for automatic approval. In case of nine categories of industries, viz. mining service, basic metal and alloy, electric generation and transmission, non conventional energy generation and distribution, construction, land and water transport, storage and warehousing service and some manufactures like industrial and scientific instruments, the RBI grants automatic approval of foreign collaboration even if foreign participation goes up to 74 percent In case of infrastructure projects of this groups automatic approval can be availed even with 100 percent foreign equity participation. In 48 industries, automatic approval is granted, if the foreign equity participation goes up to 51. Whereas in case of three categories of industries, such as mining of iron ore, metal ore, and non metallic minerals, foreign equity participation should not exceeds 50 percent if automatic approval is concerned.

If foreign investors wishes to have greater participation in equity than that mentioned above, documents have to routed through FIPB which is under the Industry Ministry of the Indian Government. FIPB even sanction foreign investment up to the limit of 100 percent in Indian companies, which are either unable to raise fund from the market or in case where at least half of the output s meant for export. It is also done in cases where foreign investor is to bring in proprietary technology.

The new policy extended FDI to trading, hotel and tourism related companies, units of export processing zones and 100 percent EOUs, banking and non banking financial service of course, with varying degree of foreign equity participation.

FDI does not always involve investment in cash. A purely technical collaboration involves permission to use patents or trademarks and transfer of technology for which the Indian company pays royalty, technical service fees, etc. In case of technology import, too, the new policy provide for automatic approval of the collaboration agreement involves royalty payment up to $ 2 million (net of taxes) to be made in lump sum amount or up to 5 percent of domestic sale and 8 percent of export even a ten year period from the date of agreement. As regards hiring the foreign technician there is no bar if the RBI guidelines are followed. There is no bar also on the use of foreign brand name.

NRIs making foreign investment (FDI) get special treatment. They make direct investment on both repatriable and non-repatriable terms. In case of repatriable investment their share can go up to 100 percent of the equity if the project concern high priority industry, housing and real estate development, air taxi operation, sick units, 100 percent export oriented units or a unit in export processing zone. On the non repatriable term NRI deposit/ participation can go up to 100 percent of bonus issues in an Indian company if the company is not engaged in agriculture, real estate, or plantation.

In all, Indian government has created a healthy atmosphere for FDI inflow. It is now a member of MIGA (Multilateral Investment Guarantee Agency), which has infused confidence among foreign investors against expropriation of assets. The present government is also moving in the same direction.

In budget 2001-02, government has come out with a policy package-carrying further the ongoing economic reform programmes on trade and investment. Government has permitted except for a small negative list, access to the automatic route for FDI, whereby foreign investors only need to inform the RBI within 30 days of bringing in their investment, and again within 30 days of issuing any shares. Non Banking Financial Corporation (NBFCs) may hold foreign equity up to 100 percent if these are holding companies. In the process of liberalisation of FDI policy, the following changes have been made.

1. 100 percent FDI permitted for B to B e-commerce.
2. Condition of Dividend Balancing on in consumer items removed forthwith.
3. Removal of cap on foreign investment in power sector.
4. 100 percent FDI permitted in oil refining.

International Financial Institution like Asian Development bank, International Financial Corporation, Common-wealth Development Corporation, German Investment Development Company (DEG) etc., are allowed to invest in domestic companies through the automatic

route, subject to SEBI/RBI guidelines and sectors specified cap on FDI.

For portfolio investment also, economic reform policies are carried further. In the budget for 2001-02, it was proposed to raise the limit for portfolio investment by FIIs from normal level of 24 percent of the paid up capital of the company to 40 percent, subject to the approval of General Body of the shareholders by a special resolution. The government has been liberalising the guidelines for ADR/ GDR in a phased manner. The initiative taken in 2001-02 include in :

1. Indian companies have been permitted to list in foreign stock exchanges by sponsoring in ADR/GDR, issues with overseas depositories against shares held be shareholders subject to contain condition.

2. All companies that have made an ADRs/GDRs issues earlier and listed abroad have been permitted the facility of overseas business acquisition through ADR/GDR stock swap to under automatic route subject to condition that include adherence to FDI policy.

3.3.4 Size And Growth Of Capital Inflows To India

It is being now more than a decade to evaluate and to make a comprehensive study of the expansion and growth of capital inflows into India. India started its economic reform programmes in 1991. The economic reform consisted liberalisation, globalisation and

privatisation, started under the Fund-Bank sponsored policy package designed for countries reeling under balance of payment crisis. This, in compulsion, is to be accepted to all members country seeking help from IMF to tide over this crisis.

In the Tables below, are shown total number of collaboration both technical and financial, approval foreign investment, actual inflows, actual as percentage of total approval and the exchange rate. After the announcement of NIP (New Industrial Policy) in 1991, there has been an acceleration in the flow of foreign capital in India. During 1991-92 to 2000-01 total foreign investment flows were of the order of $35.5 billion. Out of which $14.21 billion were in the form of FDI and the remaining $21.22 billion in the form of portfolio investment. This clearly shows that the preferences of the foreign firms was more in the favour of portfolio investment and much less for FDI. Moreover out of total FDI nearly 8.5 is contributed by NRIs (Table 2).

As a response to the policies of liberalisation, the foreign investors were very keen to undertake portfolio investment including GDR (Global Deposits Receipts), FIIs & Euro Bonds etc.

Approved FDI investment was highest in 1997 $ 15.7 billions, of which the actual FDI was $ 3.3 billion i.e. just 21.1 percent of total approved FDI which indicate that still a long way to go on economic reform path in order to get FDI inflows in maximum. Some economists suggest the principal factor behind all this scene is political uncertainty. Forex reserves touched a record high of $ 51 billion in April 2002. All of these are shown in the Table 3.

3.3.5 Sectoral Distribution of FDI

Table 4 provide the industrywise break-up of approvals of FDI. The data reveal that nearly 75 percent of the FDI approvals were made in the priority sectors such as power, fuel, metallurgical industries, electrical equipment and software, chemical and fertilisers, transportation, industrial machinery and telecommunication. As against it, 25 percent of investment approval were made in non priority areas like food processing industries, service sector and trading, drugs and pharmaceutical, etc. ISID study underlines the fact : *"Liberalisation of Industrial licensing in the form of freeing public sector reserved areas has been the single most important factor that influenced the sectoral distribution of FDI."*

It is really strange that industrial machinery accounted for only 1.4 percent of total approved investment. Explaining this situation, ISID study mentions : *"With steep reduction in custom duties for capital goods sectors, foreign investors might be finding it more advantageous to export to India rather than to manufacture within the country. It has also been observed that this sector has not been receiving much attention even in the technical collaborations."*

However, the share of consumer goods sector is 15.3 percent and that of capital goods sectors and machinery 18.1 percent and infrastructure 49.1 percent in FDI approval during 1991-1996. While talking about the share of consumer goods sector, two noticeable factors can not be ignored – **First,** Pepsi and Coca Cola dominate the food processing industry with Rs. 1000 crore and Rs. 2700 crore

worth of FDI approval respectively. **Secondly,** Hindustan Lever Limited has recently taken over a number of Indian Firms (Brook Bond, Lipton), Tata Oil Mills and several other firms and created a subsidiaries.

3.3.6 Extent of Foreign Ownership

Under Foreign Exchange Regulation Act (FERA) percentage of equity ownership allowed to foreigners was restricted to 40 percent and this acted as a deterrent to foreign firms acquiring a dominant position. After the announcement of Industrial Policy of 1991, majority share of foreign companies was permitted up to 51 percent for the automatic approvals, but this limit was raised to 74 percent in January 1997 in case of Foreign Firms and 100 percent for NRIs (Non Resident Indians). The government could also permit 100 percent FDI in high technology, power, and export-oriented foreign companies.

The Table below reveals the following :

1. Prior to liberalisation, during 1981-83 the distribution of foreign ownership was seen in favour of, upto 40 percent 89 percent of total ownership was in firms with foreign ownership of less that 40 percent equity.

2. After liberalisation, 100 percent foreign ownership subsidiaries accounted for 37 percent Share of less than 40 percent ownership subsidiaries fell to about 14 percent and that in range of 40 to 99.9 percent improved to 49 percent This is, therefore, a

structural change in the ownership pattern of foreign subsidiaries. Majority ownership (more than 50 percent) accounted for 64 percent of total (Table 5).

3.3.7 Financial & Technical Collaboration

Foreign collaborations are of two types : (1) Technical collaboration, in which payment is made for technology, (2) Financial approvals, which means purchasing equity of one company by another existing or new company. In India, up to Rs. 600 crores, the Industry Ministry accords approvals on the advice of FIPB (Foreign Investments Promotion Board), but larger projects over this limit are approved by Cabinet Committee on Foreign Investment (CCFI). Data shown in the Table 6 exhibits the following results :

a) Financial collaboration were just 20.1 percent during 1981-85 and their share improved to 28.8 percent during 1985-90, but rose sharply to 72 percent during 1991-97.

b) The amount of approved investment also increased sharply from Rs. 899 crores during 1985-90 to Rs. 1,73,510 crores in August 1998. Hence, there is a shift from technical approval to financial approvals during the post liberalisation phase. However, Government has been successful in rating more foreign investment in post liberalisation phase as compared to the earlier period.

3.3.8 Sources of Foreign Investment

There has been a diversified source of foreign investment in India, though mostly from the advanced and industrialised countries. The data shown below for the period 1991-2000, reveals that U.S.A. contribute the maximum 27.5 percent of the total U.K. 7.8 percent, Mauritius 11.7 percent, Japan 4.7 percent and Germany 4.2 percent These five countries are the major contributors to India, contributing 56 percent of total investment. Mauritius, being a tax shelter, is a hub of foreign investment to India from the advanced countries, so that they can save some tax, same as Hongkong is for China. NRIs contribution has been 4.8 percent However, as RBI report on currency and Finance (1999-2000) has indicated : this does not include NRI direct investment approved by RBI. If included this in investment by NRIs it emerged major contributors and economists are of the views that India should tap this investment and this has no political strings attached to it. NRIs can also bring sophisticated technology transfers because being located in the advanced countries they are more conversant with the latest technologies.

Conclusion

Foreign capital in a developing economy is usually welcomed on three grounds: they contribution to foreign exchange resources, augment the rate of capital formation and brings in scarce technology. Foreign investment in India has so far been quite modest compared to many developing countries (China, Malaysia, Indonesia, Thailand, South Korea and Philippines). A decade of reform could

not give sufficient confidence to foreign investors to consider India a safe place to invest (Chandra, 1999).

Today there is a considerable competition among countries inviting foreign investment given the declining volumes of grants and aids from international agencies and the erstwhile donor countries. This ongoing competition turns the policy ineffective in a country the moment its competitor's become attractive to foreign investment. In case of India measured regulating foreign investment have been largely ineffective since the lack of continuity in foreign investment policies discouraged new investment (mainly FDI) while encouraging rent seeking behaviour in the economy (Pant, 1996).

Economic reform of 1991 in order to tide over the crisis in balance of payment, forced India to accept the Washington Consensus which is being supported and sponsored by W.B., IMF and recently WTO. Another big jolt in this regard came when India joined WTO in 1994 and signed TRIMS clause without considering any socio-economical and political repercussion of that. The cumulative effects of all these is fastly eating away sovereignty in policy formulations and setting up its own terms and conditions before the foreign investors. This is one of the main reason why foreign investment is not going in desired areas (Kumar, 1999).

Compared to the previous two decades foreign capital in this period was generally of non official type, comprising mainly FDI, portfolio investment and NRI deposits (see Table 1). Foreign capital infliows especially FDI grows mostly in mergers and acquisition

(Chandra, 1999). 80 percent of FDI is going in financial collaboration rather than technical (Table 5). Quite a substantial amount of FDI is concentrated in metros and other capital cities of states (Kumar, 1999). FDI is not trade oriented rather competing with indigenous producers in the local market (Nayyer, 1996).

Foreign capital, whatever its size, influences greatly the growth and development of the host country through its impact on employment and wage, access to the world markets, terms of trade, market and industrial structuring, domestic firms, research and development activities, infrastructure, saving and investment and, factor productivity. This issue will be taken up in detail in the next chapter.

Table 1

Developing Countries : Aggregate Net Capital Inflow By Type of Flow, and Net Transfer

(Percentage of GNP)

Flow	**1972-1982**	**1983-1989**	**1990-1998**
Total Net Inflow			
Including china	4.91	2.87	5.00
Excluding China	5.45	2.97	4.22
Official Inflow	1.58	1.57	1.03
ODA Grants	0.53	0.62	0.56
Other official	1.05	0.96	0.47
Private inflow	3.33	1.29	3.97
Non Debt creating-Inflow	0.42	0.55	2.21
F.D.I.	0.42	0.53	1.67
Portfolio equity	0.00	0.02	0.54
Bonds	0.11	0.05	0.52
Bank credit	2.46	0.44	1.17
Short term	1.10	0.10	0.72
Long term	1.36	0.34	0.44
Memo Items			
Portfolio inflow	0.12	0.07	1.06
Interest payment	1.49	2.58	1.79
Profit remittances	0.93	0.54	0.56
Net transfer	2.48	-0.26	2.65

Source: UNCTAD secretariat calculation, based on World Bank, Global Development Finance 1999 (CD. ROM).

TDR, 1999.

Table

Foreign Investment Flows by Categories.

US $ Million

	Direct Investment			**Portfolio Investment**			**Grand Total**
	Forei-gner	**NRI's**	**Sub-Total**	**FIIs**	**Others***	**Sub-Total**	
1991-92	66	63	129	4	0	4	133
1992-93	264	51	315	1	243	244	559
1993-94	329	217	586	1665	1902	3567	4153
1994-95	872	442	1314	1503	2321	3824	5138
1995-96	1418	715	2133	2009	739	2748	4881
1996-97	2057	639	2696	1926	1386	3312	6008
1997-98	2956	241	3197	979	849	1828	5025
1998-99	2305	62	2367	-390	329-	-61	2450
1999-2000	1581	84	1665	2135	891	3026	4691
2000-01	1910	67	1977	1847	913	2760	4737
Total	13798	2601	16379	11679	9573	21252	37775
	(34.2)	(8.5)	(42.7)	(30.1)	(27.2)	(57.3)	(100.00)

* - others include investment flows, Euro-equities (GDR amount raised by Indian Corporates) and offshore fund.

L - Figures in brackets are percentage of total investment.

Source: Government of India; Economic Survey (1999 – 00 & 2000 – 2001).

Table 3

Foreign Direct Investment: Approved Vs. Actual.

Years	Approvals		Actual Investment		As % of Approvals	Foreign Exchange Reserves in Million US $
	Rs. Crores	US $ Million	Rs. Crores	US $ Millions		
1991	739	325	351	155	47.7	5834
1992	5256	1781	675	233	13.1	9220
1993	11,189	3559	1786	574	16.1	9832
1994	13591	4332	3009	958	22.1	19254
1995	37,489	11,245	6720	2100	18.1	25186
1996	39,453	11,142	8431	2383	21.4	21687
1997	57149	15752	12085	3330	21.1	26427
1998	25103	6132	8433	2073	33.8	29367
1999	-	-	-	-	-	38036
2000	-	-	-	-	-	4281
2001	-	-	-	-	-	51000
Total	189968	54268	41490	11806	21.7	

Source: Economic Survey, Government of India, 2001-02.

Table 4

Sectoral Distribution of Foreign Investment (August 1991 to July 1997).

Industry/ Sectors	No. of Approvals	Approved Amount Rs. Crores	Share in Total Investment (%)
A. Priority Sectors			
Power and Fuel	339	54104	31.2
Telecommunication	346	31466	18.2
Chemical (other than fertiliser)	645	11034	6.4
Metallurgical Industries	233	10982	6.3
Transport Sector	425	10632	6.1
Electrical Equipment's (including software)	1407	8987	5.2
Industrial Machinery	413	1931	1.1
Sub-Total	3808	1,29,136	74.5
B. Non-Priority Industry			
Service Sector	528	10962	6.3
Food Processing Industry	546	8132	4.7
Hotel and Tourism	212	3489	2.0
Textile (including dyed & printed)	417	2764	1.6
Paper and pulp (including paper products)	85	2265	1.3
Fermentation industries	41	1125	0.7
Sugar	6	1001	0.6
Others	2499	14539	8.4
Sub-Total	4332	44277	25.5
Grand Total	8140	173413	100.00

Source: Based on the data provided in Ministry of Industry, Newsletter, September 1998.

Table 5

Distribution of Approved Investment According to Foreign Share.

Foreign Share (%)	No. of Approvals	Approved Amount Rs. Crores	Share in Total (%)
A. 1981 to 1983			
Less than 10%	6	1.1	0.5
10-25%	70	25.0	11.5
25-40%	160	168.3	77.2
40-50%	9	10.6	4.9
50-74%	22	11.2	5.1
74-99.9%	5	0.4	0.2
100%	2	1.4	0.6
All Cases	274	218.0	100.0
B. August 1991 to August 1998			
Less Than 10%	324	547	0.4
10-25%	869	4857	33
25-40%	1229	14768	9.9
40-50%	1629	32949	22.0
50-74%	1669	26371	17.6
74-99.9%	640	14239	9.5
100%	1334	55840	37.3
All cases	7694	149570	100.00

Source: Database Developed at Institute of Studies in Industrial Development (ISID), Delhi on the basis of SIA Newsletter, 1998

Table 6

Financial and Technical Collaboration (1981 to 1998).

No. of Approved Collaboration				% Share of financial collaboration	Investment Approved Rs. Crores
Year	**Financial**	**Technical**	**Total**		
1981-85	688	2740	3428	20.1	375
1986-90	1154	2855	4007	28.8	899
1991	289	661	950	30.4	534
1992	692	828	1520	45.5	3879
1993	785	691	1476	53.2	8862
1994	1062	792	1854	57.3	14190
1995	1355	982	2337	58.0	32070
1996	1559	744	2303	67.7	36150
1997	1665	660	2325	71.6	54890
1998	820	433	1253	65.4	22930

Source: (1) India, Ministry of Industry, Handbook of Industrial Statistics.

(2) Secretariat of Industrial Approvals (SIA) Newsletter, September 1998.

Table 7

Countrywise Foreign Investment Approved (August 1991 to August 1998)

S.NO.	Country	Amount (Rs. Crores)	% of Total
1	USA	42,080	27.5
2	Mauritius	17,941	11.7
3	U.K.	11981	7.8*
4.	NRIs	7425	4.8
5.	Japan	7213	4.7
6.	Germany	6461	4.2
7.	South Korea	6031	3.9
8.	Malaysia	5444	3.6
9.	Israel	4227	2.8
10.	Belgium	3905	2.6
11.	Netherlands	3724	2.4
12.	France	3337	2.2
13.	Australia	3337	2.2
14.	Singapore	2988	2.0
15.	Italy	2633	14.7
	Others	44831	25.8
	Total	173508	100.00

Note: Others include GDRs of Rs. 18149 crores.

Source : Based on Data provided by Ministry of Industry SIA, Newsletter, September 1998.

Chapter IV

FOREIGN CAPITAL AND ECONOMIC DEVELOPMENT IN INDIA

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Chapter IV

Introduction

Foreign Capital can be divided broadly between two heads - foreign direct investment (FDI) and portfolio investment (PI). There is a substantial difference between them, as explained in the last chapter. They are different both in time and space. PI consists of FIIs, ADR, GDR, Eurobonds and others. Foreign institutional investment (FII) is investment by foreign institutes like Merill Lynch and not by any individual separately. They invest in the share markets of the host country. GDRs are negotiable instruments meant for raising equity in the international financial market. They are created by overseas depository bank, which are authorized to issue GDRs outside the country. They can be listed in any overseas stock exchange and may be purchased or transferred by nonresidents in foreign currency. American Depository Receipts (ADRs) remains the most preferred form of foreign equity investments by the U.S. investors.

Eurobonds are standard international bonds with the following characteristics: the currency of the bond is not that of the place of issue, the issuers of the bonds are foreign to the place of issue and the bonds are not sold in the capital market of the country but are distributed world wide. Eurobonds floated by Indian companies are commonly referred to Foreign Currency Convertible. Bonds (FCCBs). Others include a financial investments introduced from time to time, in order to raise funds from the international market, like Resurgent India Bonds (RIBs) issued to NRIs by SBI in 1999.

Apart from FDI and PI, another form of foreign investment is the investment by NRIs (Non Resident Indians). Their role is significantly increasing in the development financing of India, given their special status, as provided in each budget. But various studies have concluded that, given the size and nature of NRIs deposits/investment it is highly volatile, despite given various policy incentives, like location advantage, tax holidays etc. These studies really prove right when NRI investment behaviour is observed in the crises time of Indian economy in 1991.

This chapter has been divided into various sections. The study of, how does foreign investment through good or bad for economic development of developing countries, is taken up in section 4.1 Section 4.2 talks about the role of FDI in economic growth. Similarly in section 4.3, the role of portfolio investment in economic growth is analyzed. Likewise, Section 4.4 and 4.5 talk about the relation of foreign capital with trade, poverty and unemployment and technology transfer respectively, in the developing countries.

4.1 Foreign Capital and Economic Development

The development priorities of developing countries include income growth, raising investment and exports, creating more and better employment opportunity and benefiting from technological progress (UNCTAD, 1999). Governments are committed to achieve these in sustainable manner, ensuring that resources are available to future generations. The ongoing globalisation, as an international economic order, is exerting considerable pressure on developing

countries to accept the 'Washington Consensus' if to achieve these objectives.

The impact of the foreign capital on the host country's economic growth and development can be analysed both at macro and micro levels, where the former include how foreign capital influence the macro economic variables – national income (GDP), investment, savings, rate of interest, inflation, money supply and employment (Table 1) and the latter includes how various forms of foreign capital as explained in the previous section influence economic growth. The available literature on foreign capital and growth, by and large, talk about the relationship between the two, by taking 'capital inflows' as the variable factor and draw results but it will altogether be a different scenario when 'net capital inflow' replaces capital inflows. As massive capital inflows into the developing countries is always followed by a significant capital outflows, and sometimes, net capital inflows turns out to be negative.

Foreign capital brings, capital (both physical and human), technology, management etc, to the host countries. Hence foreign capital can play an important role in the development process of the host countries in many ways. However, the objectives of foreign capital differ from those of host countries: government in the host country seek to spur national development, while foreign capital seek to enhance their own profitability and competitiveness .

Growth in any country, depends on a variety of factors, and capital (both foreign and indigenous) is one of them, capital helps in

economic development in a variety of ways (Kelecki, Financing Economic Development). But a given level of foreign capital gives different results to different countries which simply indicate to the fact that it is the interplay of these variables of growth giving different set of economic results. Manufacturing based FDI will positively impact income growth whereas service FDI will not (Poor and Thompson 1998). Growth enhancing technology transfers of foreign capital are more likely to occur when the technology gap is smaller between home and host country. Significant positive impact of foreign capital on growth is stronger for countries with higher level of development (De Mello, 1997). Balasubramanyam et al. (1996) find that foreign capital has a greater positive impact on growth in countries promoting exports compared to countries exhibiting import substituting strategies.

The Keynesian economy, aggregate output is segregated among consumption expenditure, investment (both foreign and domestic) and net export i.e.

$$Y = C + I_D + I_F + X - M \text{ where}$$

C: Consumption, I_D domestic investment, I_F foreign investment, X: Export and M: Import. Talking in Indian context where foreign capital both as percentage of GDP (Less than 1 per cent) and total capital formation (2.25 percent), is very small, can not be expected to have any significant impact on the economic growth. Given the nature of macro economic variables and the kind of external policies framework, foreign capital especially (FDI) is having a

tendency towards financial collaboration rather than technical (Table 6). Moreover, around two third of FDI goes straight in M&A (Mergers and Acquisitions) hence substituting rather than supplementing I_D (Table 4). Developing countries are resource lacking economies. In order to attract more and more foreign capital, these economies have to have high rate of interests (at least higher than LIBOR). Though, to some extent it helps in bringing short term capital but it exerts negative impact on investment climate in corporate sector. Which further not only breeds inflation but also brings the economy in the trap of unemployment's problems and the economy spirally plunge into crises.

In any economy with liberal trade and foreign exchange market, any foreign capital runs parallel with the appreciation in the currency which not only shoots up current account deficit but also distorts the terms of trade for domestic producers. The developing country like India where marginal propensity to consume is high, foreign capital inflows, instead of investment, further accelerate the growth of consumption expenditure. Hence no productive investment in the economy is generated by foreign capital (Table 1).

According to endogenous growth theory, the rate of technology progress is the main determinant of long run growth rates. Due to foreign capital impact on technology and human capital, the growth impact of foreign capital should be positive for investment flowing from technologically more advanced countries to less developed countries. However, the scope of this impact depends on the amount and type of efficiency spillovers to domestic firms and other

externality associated with foreign capital. In many cases there is a little scope for technology transfers such as the case where the technology gap is maximum. Since foreign capital led growth may be limited, policy making should focus on improving the environment for domestic investment rather than designing incentives to attract only foreign capital.

The Mexican crises of 1994-95, the currency crisis of South East Asia in 1995 and recently crises of Argentina (2001-2002) clearly revealed that global financial flows are volatile, and create economic instability. The World Bank, IMF, W.T.O and many developed countries including U.S. are putting pressure on developing countries to further open up their financial service sector and move towards capital account convertibility or full currency convertibility.

The recent and the ongoing crises have given rise to serious debates on how to control economic instability. There should be a international mechanism to regulate financial markets, as the existing international financial institutions (IFIs) have failed to do so (Soros, 1996).

4.2 FDI and Growth

Among the various components of foreign capital – FDI is the most preferred by the host country. Since FDI is for long term, less volatile and causes less strains on the balance of payments. According to endogenous growth theory, FDI may play an important role in the host country's economic growth. FDI not only brings capital, but represents a bundle of new technologies, skills, services, and even

ideas. The potential for FDI induced growth stems primarily from the possibility that spillovers from this bundle will bring increasing reference to domestic investment due to these spillovers, (Ruffin, 1993). An obvious example is FDI related technology transfers from more technologically advanced countries to less developed ones. Given all these, various studies, conducted to analyse the impact of FDI on growth are either inconclusive or proving this relationship to be negative.

In the developing countries, any move towards liberalization of FDI, ask for policy changes in the sector or areas directly or indirectly related to FDI flows. For instance, liberalization of capital (especially FDI) also provide incentives to go for trade liberalization. Which in most of the cases adversely affected domestic industry (infant industry argument) in economies having prolonged current account deficit. FDI crowds out domestic firms through their competing activities. The other form of this crowding out take place in the Financial Market' TNC have privileged access to finance which reflect an uneven playing fields for domestic firms because of segmentation in local factor market. Both these forms of crowding out raises legitimate policy concerns.

FDI through transfer pricing adversely affect the terms of trade for tradable goods which further distort the whole price mechanism. FDI meant for technology transfer does not, infact prove it in realization, i.e. FDI is not going for high technology areas except telecommunication.

A large inflows of FDI can add to foreign exchange and investment resources in the host country, but it may deter the development of local firms or create exchange rate problems (Table 2). The desire to generate employment may lead governments to favour labour intensive, low technology investments. FDI with high technology exerts employment problems in the economy.

To a significant extent, the outcome of FDI depends on how well a host country bargains with international investors. However the capacity of developing country to negotiate with TNCs is often limited (except China). The skills and information available to TNCs, tend to be of better quality. In many cases particularly in export oriented investment projects where natural resources are not a prime consideration, FDI have several alternative locations. Host countries may have alternative foreign investors, but they are often unaware of them.

Managing FDI effectively is a demanding task. A passive 'laissez faire' approach is unlikely to be sufficient because of deficiency in markets and existing institutions. (UNCTAD, 1999). The performance of any approach depends critically on the ability of the government to 'deliver'. If the administrative capabilities are not appropriate to the skill implementation, negotiations and implement abilities are needed.

A 'laissez faire' FDI strategy may yield benefits, particularly in a host country that has underperformed in terms of competitiveness and investment attraction, because of past policies (UNCTAD, 1994). A strong signal to the investment community that the economy is

open for business can attract FDI into areas of comparative advantage. However, there are two problems. First, if attractive locational assets are limited, or their use is held back by poor infrastructure or non-economic risk, there will be little FDI response. Secondly, if FDI comes, its benefits are likely to be static and will run out when existing advantages are used up. To ensure that FDI is sustained and enters into new activities necessarily require policy intervention, both to target investors and raise the quality of local factors. Needless to say, for the great majority of countries the form of intervention has to be different from traditional patterns of heavy inward orientation and market friendly policies. It has to be aimed at competitiveness.

4.3 Portfolio Investment and Economic Grwoth:

Portfolio Investment, a short term is an investment into a host country through the stock market. Compared to FDI it is more volatile in nature i.e. highly sensitive to the socio, economical and political conditions of a country. Taking the record of the situations that developed in many crisis ridden economies for example Mexico in 1994-95; South East Asia (1997-98) and recently in Argentina (2001-02), it has become amply clear to other developing countries, undergoing economic reforms, that portfolio investment is sensitive to the herd instinct behaviour in the stock market. Hence it can trigger economic crisis any time where market sentiments are shaken up. Various studies conducted to find out the relationship between portfolio investment and growth of the economy, are not supporting their positive relationship. Similarly the argument that the entry of

foreign portfolio investors will boost a country's stock market and economy does not seem to be working in India. (Pal. 1998). With the increased PI there has been a rise in uncertainty and skepticism about stock market.

There are certain mainstream view about how portfolio investment can be beneficial for host country's economy. According to this, the benefits to the country are realized through the stock market i.e. with portfolio investment share price shoots up and high price earning (P/E) ratio to the firms.

A higher (P/E) ratio leads to a lower cost of finance. Hence higher investment in the economy. But this argument stands wrong if the increased equity investment is in the secondary market. Which also indicates towards a tendency of mergers and acquisitions (M&A) and hence no real investment in the economy rather is harmful for the economy in terms of domination of firms, low investment in infrastructure, shrinking labour market, etc. (Table 4).

One of the main reasons behind the deleterious role of stock market emerge due to the dilemma posed by modern capital. In the modern capital markets, speculation in the secondary market leads to a situation where the players indulge in outguessing the market in forecasting changes in short term financial ratios. This turns the secondary market in some kind of a casino where people speculate on other people's speculations. (Pal, 1998). This seriously hinders long term investment and growth of the economy.

Indian economy is fastly becoming a stock market based economy. To such economy individual investors neither have the means nor the incentive to monitor and control corporate management and the selling-purchasing of shares behaviour of stock market, is highly disruptive and wasteful. Since, enterprises here are generally valued on the basis of short term financial performance rather than long term, hence no real investment.

These negative features of the stock markets generate more costs than benefits. The costs include persistent misalignment of prices of financial assets, resulting inefficiency of allocation of resources, sharply increased short term volatility of asset prices, resulting in great uncertainty; excessive borrowings to finance speculative asset purchases and consumption, resulting in unsustainable stocks of debts and reduced household savings and less autonomy in pursuing interest rate and exchange rate policies in accordance with the need to trade and industry.

All of these costs cited above, really express the need to some sort of controls in order to cool off the hot money nature of these investment and making the stock market more vibrant and efficient. It is being told and learnt that there are no effective mechanisms to regulate and control portfolio investment and it should be left to the market, to control themselves on the principle of self discipline. Any controls on capital movements are opposed but recent financial issues in Mexico, South East Asia and Argentina show that these countries were following market friendly policies and yet they were punished by the same market forces. In the words of Malaysian Prime Minister

Mahathir Muhammed "A world trading system can not rely entirely on market forces..... since the beginning of time, market forces by themselves have been exploitative".

4.4 Foreign Capital and Trade Promotion in Developing Countries

Globalization has coincided with large increases in the international movement of goods and capital. Global growth of trade and FDI has been strong, although since the mid 1980s, the growth of FDI has surpassed that of trade. In fact the value of global production by MNCs and its affiliates now exceeds the value of the total world trade (McCorriston, 2000). The globalization of production through FDI and its relationship to trade is a key area of interest for researchers and policy makers alike.

We have clearly mentioned in the earlier chapters that foreign capital is guided by push and pull factors. Among these, trade prospects are one of the critical factors. Trade prospects include prospects of increasing export from the host country, import liberalization, size of the domestic market, domestic competition i.e. competition with the local firms, etc. Hence foreign capital will necessarily lead to acceleration in growth of trade in the host country.

There are various points put forward that support the nexus between trade and foreign capital to be complementary. Among these include capital helps in raising saving ratio by supplementing domestic saving, deepening stock market, financing infrastructure and establishing global link. The effects of capital inflows in recipient

country are considered good, atleast for long term capital. On the basis of the nature, objective and size of foreign capital, the nexus between foreign capital and trade, has been divided into three phases. The colonial phase, the phase of import substituting industrialization and the current phase of globalisation (Chandrashekhar, 1998). We shall confine only to the current phase. A certain school of thought take FDI as being the principal engine of industrialization of the developing countries. One set of countries whose experience is often quoted to support that judgment are now the newly industrializing countries in Asia like China, Indonesia, Malaysia and Thailand, all of which rank among top ten developing countries in terms of the stock of inward foreign capital (especially FDI). All of this indicate towards an economic thinking that high degree of openness in trade and capital combined with a not too interventionist government, provide the basis for export led growth driven by foreign investment. To support these we can quote from the UNCTAD Report, 1994.

"….. In FDI area, liberalization is most important policy trend of the 1990s, as part of broad based effort to attract foreign capital. This trend is embedded in a broader liberalization movement covering international trade in goods, external financial transactions, transfer of technology and now recently service and some aspects of labour movement. That seek to enhance economic efficiency through the eliminations of market distortion caused by restrictions or discriminatory governmental measures. These policies are interrelated and mutually supportive. Together they are one of the preconditions

for, and allow the faster development of, the emerging international production system, while receiving additional impetus from it".

But there would be a fundamental flaw if the experience of these countries (Latin American and South East Asian economies) is set before India while talking about positive nexus between foreign capital and trade. Reasons with the stage of development those economies started off with liberalizing their external sector, India stands no where to that stage, Each one of them had crossed a certain thresh hold of per capita incomes and stage of industrialization. Today India's per capital income stands at about $ 350 and the share of industry in total GDP is around 25-26 per cent. As against this, in respect of all the countries studied, as early as in the early 1980s, their per capita GNP level had ranged from $ 580 to $ 2500. Likewise by early 1980s, these countries had attained relatively higher level of industrialization, ranging from 30-40 percentage of GDP. These high level of per capita income and stage of industrial growth represented certain economic strengths to withstand and sustain the ramifications of liberalized capital flows. It is important to note that liberalization of capital flows was never an instrument of development in those countries; it was rather a consequence of their certain stage of development that involved these economies to open up their financial and external sectors (Ganesh, 1992).

Though foreign capital (especially FDI) bring with it capital, technology, market access, employment, skills and management, but simply opening to trade and foreign capital, does not mean that the host country will obtain or benefit from them in totality. As noted

above there are market failures in the investment process and divergence between MNCs and national interests. (UNCTAD, 1999). In the current phase of globalization, trade promotion is the main objective of most developing countries including India. In fact FDI though being small in size, as percentage of GDP or total capital formation, greatly affect the domestic enterprise sector by its very crowing out nature (Table 2 and 5). This takes one or both of the following two forms: first, in the product market, by adversely affecting learning and growth by local firms in completing activities, second, in financial market, by reducing access or raising costs to local firms. Both of these forms, among its various adverse impacts down size the trade of the host country.

As has been observed in the recent experience of emerging economies and the followed up crises, massive capital inflows trigger exchange rate appreciation (in economies where exchange rate is market determined) means exports costly and cheap import' hence bulging out of current account deficit. Same example also applies to India if it goes for capital account convertibility.

The performance of exports largely depends upon the surplus available for exports and the demand for such surplus in the international market. Foreign capital may help in increasing the supply by increasing the capacity of production whereas domestic demand might be required to be checked. Besides this, terms of trade should be favourable and quality oriented measures should also be started. Foreign capital may improve export possibility by (1) increasing competitiveness by improving the technology (2) changing

the relative price of currency (3) improving terms of trade between two countries by constant favourable balance of payment position (4) increasing export service through increased productivity and, (5) creating demand by producing quality product. Capital flows are however, a double edged weapon as could be seen in the Mexican, South East Asian and recently Argentina crisis. Economic Policies should thus be tailored so that the above defined objectives about export promotion could be realized in the host country.

By seeing the experience and attitude of TNCs in post reform period in India, not serving the export possibility, serving their parent companies, poor investment in priority areas, etc. It has become amply clear that there is a clear divergence between the interests of foreign capital and Indian government. Hence foreign capital can no longer be relied upon for trade and development of the country. (See Table 3)

4.5 Foreign Capital and Poverty and Unemployment

Recently, a growing number of policy makers have touted the potential for global economic integration to combat poverty and unemployment. "Globalization reduces poverty because integrated economies tend to grow faster and this growth is usually widely diffused," (World Bank, 2000). Yet the empirical evidences suggest that reduction in poverty and income inequality remain elusive in most parts of the world and moreover, that greater integration of deregulated trade and capital flows over the past two decades has

likely undermined efforts to raise living standards for world's poor (Example, African and Central Asian population)

In 1988, median income in the richest 10 percent of the countries was 88 times greater than in the poorest 10 percent; by 1999 that gap had grown to 122 times. Inequality has also grown within many countries. Over the same period, any gains in poverty reduction have been relatively small and geographically isolated. The number of poor people rose from 1987 to 1998; and the share of poor people increased in many countries- in 1998 close to half the population were considered poor in many parts of the world.

While many social, political, and economic factors contribute to poverty, the evidence shows that unregulated capital and trade flows contribute to rising inequality and impede progress in poverty reduction. Trade liberalisation leads to more import competition and to a growing use of the Threat to move production to lower wage level. Deregulated capital inflows and more frequent crises, while simultaneously limiting the ability of government to cope with this crisis. Economic upheavals disproportionately harm the poor, and thus contribute to the lack of success in poverty reduction and to rising income inequality.

The world poor may stand to gain from global integration, but not under the unregulated version currently promoted by the World Bank, IMF and WTO. The lesson of the past 20 years is clear: it is time for a different approach to global integration, whereby living standards of the world's poor are raised rather than jeopardized.

The probability of financial crisis in developing countries rises in direct relation to increases in unregulated short term capital inflows (Weller, 2001; Easterly and Kracy 1999). Rising short-term capital inflows result in increased speculative financing and subsequently rising financial instability. Financial crisis reduce the likelihood for the poor to escape poverty through economic growth because they are ill equipped to weather the macro economic shock (Bannoster and Chugge 2001: Lustig 1998, 2000). Financial crisis also lower short term growth rates and it is estimated that poverty increased by 2 percent for every percent decline in growth (Lustig 2000). Developing countries are prone to experience more severe economic crisis with greater frequency than are developed countries, leading to greater inequality between them (Lustig, 2000). Trade liberalisation in Latin America led to widening wage gaps, falling real wages for unskilled workers (often more than 90 percent of the labour force in developing countries) and rising unemployment (UNCTAD, 1997).

In assessing global poverty trends the World Bank relies on a study that highlights the World Bank's "Global Poverty Monitoring" data base and provides an overview of poverty trends from 1957 to 1998 (Chen and Ravallion, 2001). The authors themselves, though, conclude that " in the aggregate, and for some large regions, all....measures suggest that the 1990s did not see much progress against consumption poverty in the developing world". As per one of the report of IMF, "progress in raising real incomes and alleviating

poverty has been disappointingly slow in many of developing countries" (IMF, 2000, part IV, p.1)

The drivers of FDI location have important policy implications at the regional, national and local levels. Natural resources and unskilled labour (which are 90 percent of labour force in developing countries) and national markets, are decreasing in significance. The new drivers are skills, technological capacities, supply network, good logistics and strong support institutions to attract foreign capital. This simply means that foreign capital is offering only static advantages and not dynamic to the host country. India squarely fall in this category.

When foreign capital is coming, several backward and forward linkages emerge in the host country and in the process, with efficient supply and demand networks, employment opportunities are generated. But several studies have noted that the propensity to source locally is often lower among foreign than domestic buyer firms. (UNCTAD, 1999).

Foreign investment, of long term in nature, can be divided between greenfield and investment in mergers and acquisitions (M&A); former is the investment in the primary market of stock market and the latter in the secondary market. It is widely acknowledged by the experts and policy makers that greenfield investment add productive capacity in the host country whereas the investment in mergers & acquisition is simply a transfer of ownership from the local to foreign hands.(Table 4) In India, two third of foreign

investment (FDI) directly goes in M& A and the remaining can be considered "greenfield". Now in this investment scenario there are three issues which are worth mentioning. One, foreign capital as percentage of local domestic capital formation or GDP is very small 2.1 percent and around 1 percent respectively, hence no considerable impact an growth takes place, and thereby no reduction in poverty and unemployment can be visualized. Second, as quite a significant part of foreign investment go in M& A, no additional productive capacity and, no employment generation is done. Third, foreign investment, especially FDI brings know how, know why, management, personal trainee, etc which is both capital and knowledge intensive. Chances that employment generation would be there, seem quite bleak.

Taking an overview of this whole literature, it becomes amply clear- that enhancement of productive capacity (Investment in R & D) proper negotiation with foreign investors, investment in health and education etc. are pre-requisites conditions for growth and development and these are only possible when the government in coming forward with the strong measures.

4.6 Foreign Capital and Technology Transfer

According to endogenous growth theory, the role of technological progress is the main determinant of long run growth rates. Due to impact of FDI on technology and human capital, the growth impact of FDI should be positive. However, the scope of this impact of depends on the amount and type of efficiency spillovers to domestic firms and

other externalities associated with this form of foreign capital. In many cases, there is very limited scope for technology transfer such as the case where technology gap is wide. There are also evidences that countries must have reached a threshold development in order to realise the benefits of FDI related knowledge spillover. In such economies, policy making should focus on improving the environment for domestic investment rather than designing incentives to attract only FDI.

Technological spillovers can occur through four channels. First, FDI may stimulate technical upgrading through backward and forward linkages with local suppliers and customers. Second, the demonstration effect may cause local firms to follow foreign firms and become more productive. Third, increased competitions from MNCs, may force local firms to be more efficient or to introduce new technologies in order to maintain their market share. And fourth, MNEs may provide workers training in the use of new technologies thereby reducing the cost of adoption for other firms when there is labour turnover.

Various empirical studies have been done on FDI and technology transfer, which fall into two groups. The first group of studies try to correlate the presence of foreign firms within a sector to the productivity' of local firms in that sector .The second group use production function to analyze spillover typically in a case study format. Over all the empirical evidence suggests that sectors with higher level of foreign involvement exhibit higher productivity, or higher productivity, growth, or both (Saggi, 2000). Of course] this does

not necessarily mean that FDI causes an increase in productivity. In fact, in the FDI - growth relationship, one could argue that that FDI is drawn to sectors that tends to higher productivity level.

Aitken and Harrison (1999) analyze productivity for a panel of Venezualian firms. They find that foreign equity participation is positively correlated with plant productivity for small firms, but that FDI correlates negatively with the productivity of domestic firms. The overall result is a weakly positive correlation between foreign investment and productivity of the entire industry.

Another positive correlation between FDI and productivity is reported by Blomstrom (1995) from micro data from Indonesia. He correlates the ownership share of MNCs affiliates with productivity and finds that domestic establishments benefits from spillovers. However the degree of foreign ownership does not effect the degree of spillovers.

On the other hand, there are several studies which find a negative or no significant correlation between foreign investment and local firm productivity. Using a panel data set at the firm level to test the effect of FDI on domestic firm productivity in Bulgaria, Romania, and Poland, Konings (2000) find no evidence of positive spillovers in Poland and negative spillovers in Bulgaria and Romania. He concludes that the competition effects of MNEs affiliates outweighs any positive technology effects. The new industrialized economies (NIEs) were among the first developing countries to benefit from Japanese investment and / or technology within the context of either

liberal economic regimes, as in Singapore and Korea (Chanderasekhar, 1992).

More contrary evidences to FDI technology transfers capacity comes from a study of Reserve Bank of India in 1996. Jha, (1996) and Kumar, (1994), report that FDI has not contributed significantly to India's technological capacity or export competitiveness. On the other hand, the study says that positive contribution of FDI may include raising total factor productivity by creating a more competitive environment leading to technological upgrading, better management and other improvement in other sectors. Of course, this highlights the complexity in determining the overall impact of FDI with in a country.

A study on the possible impacts of FDI on the chemical industry in India between 1979-80 to 1989-90 reveals some interesting results- FDI had a negative association with R&D intensity (Jayaraj, 1989). He further explains that substitution dominated the influence of FDI on local R & D. On the other hand, import of technology is found to be having positive association with R & D intensity. The cost of FDI led technology transfer is, significantly higher than import of technology under licensing, though statistically it is difficult to prove (Kumar, 1985). He further emphasized the role the government can play not only for technological development across sectors and time but also in the facilitation and promotion of enterprise-level technological efforts. Without strategic intervention by their respective governments, the Japanese and Korean successes in automobiles and consumer electronics would not have been possible. The supportive role of the government is thus a necessary condition

for the development of technological capability of latecomers to industrialization (Nayyer, 1997). Literature is widely available that summorise evidences on active and extensive government support to R & D activities in OECD countries (Kumar & Siddharatha, 1997) there was a 'technology race', among them.

World Bank refers India's ability to build technological capability in sectors such as petrochemical, fertilizers, industrial machinery, telecom switching, super computing etc. These capabilities, however, have been threatened by the indiscriminate liberalization and lack of preferential treatment.

4.7 Black Economy in India: In Context of Foreign Exchange Shortage And Shortage Of Investment Resources.

Black economy deals with all those economic activities generating black income, which may range from tax evasion by small producer to big security seams (Harshad Mehta and the recent Kirit Parikh case, well known to all). This is variously referred to as, parallel economy, 'unaccounted economy', 'illegal economy', or 'unsanctional economy'.

Black economy is not a new concept, rather date back to pre-independence period. However,with the attainment of independence and the advent of planning, the magnitude of the black economy has grown and proliferated to such an extent that it has begun to play a dominant role in moulding state policies, in changing the structure and composition of output, in promoting a class which derives its maximum power from black income. However, the great irony is that,

even today there is, not only poor understanding of subject, but also, less reference is found on the policy formulation. Hence the need to incorporate the black economy is not simply an empirical matter, but a theoretical necessity (Kumar, A. 1999).

Various attempts have been made to quantify black income in India. Studying these various estimates is beyond the scope of this chapter. In the wake of unsurmountable balance of payment crises in 1991, economic reforms were set in economic policy formulation in India. Indian economy was opened for both trade and foreign investment and this sequence of opening up was further facilitated by its entry to WTO (TRIMS Clause of WTO). It is really worth looking, whether with economic reforms, black economy has further expanded, or not. In my discussion I will confine to the foreign investment only as part of economic reform, and look into how it generate black income.

Foreign investment generally come in the forms of FDI, portfolio investment, NRI deposit and loans and advances received by government. When talking about FDI, it generate black income through, transfer pricing, high dividends by investors, change in domestic policies (environment, location, sectoral distribution, technology transfer), stock market speculation, etc. For example Pepsi, Coke like other big MNCs, not only evade tax, but also create a lobby group and in the process of taking political mileage, also breed corruption and hence black economy.

As far as portfolio investment is concerned, it is also a major source of black income. More PI means, higher consumption and lower saving in the economy. PI breeds speculation in the share market and arbitrarily change in the shares prices, which means nothing, but transfer of equity ownership and in this whole process illegal income is generated through illegal means (Hawala and all).

NRI's also generate black economy through share market, real estate investment, illegal means (bribes, smuggling, drugs, and buying influences) which leaves many socio-economic and political on the white economy.

In nutshell, "While the saving rate out of black incomes as likely to be much higher than that of the white economy, the investment (both domestic and foreign) rate is likely to be lower. Since, many component of black investment are either transfers or leakages from the national economy. Hence black investment tend to: (1) Lower the rate of growth of the economy as compared to what it could have been and (2) Cause worsening of BOP."

- Kumar (1999).

Conclusion

We have seen in the chapter how foreign capital changes the fundamental economic variables of development. Any thing involving people constitute development hence understanding development in itself is a complex issue for the economic experts (Byres, 1998). Since, we are taking foreign capital as one of the determinant of

development, economists are almost unanimous, nothing concrete can be said about the impact of foreign capital on development. Proponents of liberalization and globalization argue foreign capital is the engine of growth and development and in order to prove their thesis they usually cite the example of the miraculous performance registered in South East Asian economies and China (UNCTAD, 1996). Foreign capital in itself does not exert and positive impact infact, it is the government policy and so many social and economical factors, directly or indirectly involved with it, change the nature and pattern of foreign capital.

The doctrine that greater global deregulation of trade and capital flows helps to improve inequality between countries, to raise equality within countries, and to accelerate poverty reduction. But income distribution between countries worsened in 1980, and its apparent improvement (or leveling off) in the 1990s as the result solely of rising per capital income of China (UNCTAD, 1999) where enormous population tend to distort world averages.

When it comes to India, the size, nature and pattern of foreign capital are such it is ding more bads than goods (Kumar, 1999). The way our industries are restructured and the changing employment elasticity in both organised and unorganised sector (directly or indirectly linked to foreign capital through various backward and forward links) does not support the thesis that it generate any net employment. Various studies conducted in the same regard, however, claim that with economic reform inequality has widened in the country. Globalisation favour removal of protection for indigenous

capital they suggest free access to the Indian market for foreign capital. Under TRIMS clause of WTO, it is required to give national treatment to the foreign capital. Given the disparity between the consumer in India and in the advanced world and between foreign and Indian capital taking all the factors into account, this policy favours foreign capital (Kumar, 1999, p.184). How 'good' or 'bad' foreign capital has done in India in comparison to China, is another interesting area to examine.

Table 1

Macro Economic Variables

(in U.S $ Billion)

	1993	1995	1998E	1999E
Macro outlook GDP and growth				
Factor Cost, Real Growth Rate	5.10	7.23	6.44	7.10
Index of Industrial Production	2.30	9.40	9.00	9.80
Total External Debt	90.02	99.01	95.00	98.00
Total Debt As % Of GDP at Market price	39.90	33.00	24.22	22.71
Total Debt as % of Exports	4777.08	368.65	265.70	235.27
Debt Services as % of Current Receipts	28.63	27.50	26.00	25.90
Exports (% change Y o Y)	3.30	20.21	8.00	16.50
Imports (% change Y o Y)	10.32	27.01	13.52	17.00
Trade Deficit (% of GDP)	(-)2.00	(-)0.50	(-) 3.20	(-) 3.44
External Assistance	1.86	1.70	1.20	1.80
Commercial Borrowings	(-)0.36	1.25	1.60	2.20
Rupee Debt Service	(-)0.88	(-) 0.75	(-) 0.90	(-)1.80
Other Flows	0.87	3.71	0.60	0.80
NRI Deposits	2.00	0.94	2.10	1.20
Net foreign portfolio investment (FIIs & GDRs)	0.25	3.49	3.00	3.00
Net Foreign Direct Inv.	0.34	0.62	2.50	3.50
Foreign Currency Reserves	6.40	15.10	23.54	26.18

Source : Minister of finance, CSO, RBI, industries, CMIE, Indian and Australian meteorological department, NWN & NWSL Research; NATWEST securities (1999)

Table 2

Market Share Of Foreign Firms

FDI Mkt. Share Category (Per Cent)	No Of Product Sectors	Key- sector in Each Group	Foreign Firms (Nos)	Loan Firms (Nos)	Total Firms (Nos)	Total Gross Sales (Rs bn)	Sales of Foreign Firms (Rs bn)	Foreign Total Sales (Nos)
0	23	Steel, textile fibre, telecom, cement, power, petrochemicals	0	371	371	1010	0	0
0-10	13	Refinery, fertilizer, chemicals, paper textile, engineering	20	360	380	1618	46	3
10-33	9	Electrical eqpt, drugs and pharma, white goods, auto parts, 2 wheelers, dyestuffs	25	148	173	525	110	21
33-100	10	Soaps, detergent, cosmetics, tea, food products, agro-chemicals	27	49	76	247	166	67
0-100	55	All companies	72	928	1000	3400	322	9

Source: S. Ganesh, Economic and Political Weekly, May 31, 1997

Table 3

Relationship Between Foreign Dominance And Exports/ Trade Balance

FDI –Mkt Share Category	Key Sectors in Each Segment	Total Sales Rs bn	Total Exports Rs bn	Total Imports Rs bn	Exports Sales (Per Cent)	Net FEX/ Sales (Per Cent)
O	Steel, textile fibre, telecom, cement, power, petrochemicals	1010	64.7	113.4	6.4	-5
0-10	Refinery, miscellaneous, fertilizer, chemicals, paper textile, engineering	1618	120.9	332.3	7.5	-13
10-33	Electrical eqpt, drugs and pharma, white goods, auto parts, 2 wheelers, dyestuffs	525	51.4	62.76	9.8	-2
33-100	Soaps, detergent, cosmetics, cigarettes, tea, food products, agro- chemicals	247	28.7	20.0	11.6	4
0-100	All companies	3400	265.8	528.4	7.8	-8

Source: S. Ganesh, Economic and Political Weekly, May 13, 1997

Table 4

Number of cross- border M& As whose immediate host and Immediate home countries are the same

	Developed Countries					**Developing Countries**		
Year	World	Total	European Union	United States	Total	Latin America And the Caribbean	South, East And south-East Asia	
1987	148	178	43	108	9	2	6	-
1990	497	473	178	222	24	7	16	-
1995	817	723	352	227	83	30	50	11
199	1044	852	430	262	147	82	58	45
Memorandum: Value in $billion)								
1990	20.7	20.1	6.2	10.8	0.7	0.4	0.3	-
1999	64.9	57.2	37.4	10.9	6.8	2.6	4.2	0.9

Source : UNCTAD,cross- border M& A database from Thomson Financial Securities Data Company.

UNCTAD, 2000

Table 5

Comparison of FDI Equity and Domestic Project Investments (Excluding Infrastructure and Energy Sectors)

	Number of Approvals (Aug 91- May-96)	Value (Rs bn)
FDI	2358	250
Total domestic	23885	4972
Percentage	10	5

Note: Value is foreign equity for FDI, and Total project cost for domestic.

Source : S. Ganesh, Economic and Political Weekly, May 13, 1997

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TABLE 6

Trends In FDI And Technical Collaboration

Approvals	1991 Aug-Dec	1992	1993	1994	1995	1996 Jan-July	Total
FDI	289	692	785	1062	1335	732	4915
Technical	661	828	691	792	982	464	4418

Source : S. Ganesh, Economic and Political Weekly, May 13, 1997

Table 7

Cost of technology import and total expenditure in foreign currency

Year (1)	Cost of Import Of Technology (2)	Total Expenditure In foreign currency (3)	Percentage Share of (2)in (3) (4)
1979-80	625	1119	55.85
1980-81	1627	2325	72.99
1981-82	1385	2781	49.80
1982-83	2715	3805	71.35
1983-84	2067	2985	69.25
1984-85	1780	2817	63.19
1985-86	2538	4498	56.43
1986-87	2193	4195	52.28
1987-88	2364	3594	65.78
1988-89	3636	5096	71.35
1989-90	3467	5876	64.49

Source : RBI, 1990

Table 8

India And The World Economy in 1995 : A Comparison

		India	World	Japan	USA	S. Korea	China
1.	GDP (billion $)	324	27,846	5,109	6,952	455	698
2	Exports (")	31	5,145	443	585	125	149
3	Imports (")	35	5,246	336	771	135	129
4	Inv / GDP (%)	25	23	29	16	37	40
5		68	63	60	68	54	46
Share in Total household consumption (%) in 1990							
6	Food	52		16	13	35	61
7	Consumer Durables	3		6	7	7	

Source : World Development Report, 1987 and 1990
Kumar, 1999

Table 9

Conditions of Foreign Collaboration: A Comparison

Years Category			1988-90	1991-93
1.	By Duration			
	a.	Ten year and more	11 %	36%
	b.	No duration	15.6 %	0.4 %
2.	By Royalty Range			
	a.	5 % and above	24.8%	46.5 %
	b.	3 % and above	61 %	49.4 %
3.	By Export Clauses in Technology Agreement			
	a.	Differential royalty	15%	22.3 %
	b.	100 % exports	15.12%	11.04 %
	c.	Buyback	4.7%	1.02 %
	d.	Export Oriented	36.2%	16.9 %
	e.	More than 40 % financial equity	4.8%	30.9%

Source : Subrahmanian, 1996
Kumar, 1999

Table 10

Corrected Values of Key Macro Variables (1990-91)

(figures in Rs. Crore)

	White comp.	Black comp.	Actual value
1. GDP at market prices	5,35,000	1,60,000	6,95,000
2. Primary	31%	5%	35%
3. Secondary	25%	25%	25%
4. Tertiary	44%	70%	50%
5. Gross Domestic Savings	24%	50%	30%
6. Aggregate Investments	27.5%	17%	25%
7. Incremental K/O ratio	5.	1.9	4.4
8. Exports (goods and services)	41,000	55,000	96,000
9. Imports (")	49,000	13,000	62,000
10. Tax revenue foregone		1,00,000	

Notes:

1. Figure presented under black component are indicative, based on scattered evidence and a broad understanding of the black economy.
2. The percent figures under actual value are the weighed average of the black and the white components

Item 10: refers to both direct and indirect taxes, Item 7: the rate of growth of black economy is taken to be 9 and of the white economy 5.5%. The increase in output of the black economy is not only due to investments in the black economy but also due to the misdeclared white output.

Source: Kumar, 1999

Chapter V

FOREIGN INVESTMENT IN INDIA AND CHINA: A COMPARATIVE STUDY

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Chapter V

The decade 1990s, has witnessed many structural changes on world economic front. These changes include, introduction of WTO, qualitative change in the philosophy of working of World Bank and IMF, frequent eruption of crisis in many parts of the world (especially developing countries of Asia and Latin America), etc. So much so, globalisation of unprecedented breadth and depth, in changing the world economic scenario. Many developing countries of Asia and Latin America started liberalising their economies in 1980s in order to reap benefits from this ongoing globaslisation and with the feeling not to lag behind be it the availability of capital or technology or trade liberalisation in the advanced countries. By the end of this decade they had tracked long way on reform, doubtlessely this great move forwarded was encouraged further by the improving economic performance in terms of growth, trade, saving, investment, employment, etc. Their performance was recognised world over and finally Asian economies were labelled as Asian Tigers (Thailand, Singapore, South Korea and Indonesia).

During the same period China also emerged a great economic power in terms of its expanding market size and increasing share in world trade and output. One thing which differentiate China from other emerging economies of Asia is the difference in their approach of development. The latter have been very fast in embracing liberalisation however, market was not given a big say in determining both macro and micro economic variables. China has never

compromised on core issues-like market regulation and state intervention in economic order. Given its socio-economic and political background we find it interesting to compare it with India. The comparative study also becomes important in a way that China has emerged top in attracting foreign investment without any sign of crisis (Beijing Review, 7 July, 2000).

India and China had a comparable level of real per capita income in 1950, with both economies being overwhelmingly rural and around 70 p.c. of the labour force employed in agriculture. Transportation and communication was more expensive in India. India's leaders particularly Prime Minister Nehru, firmly believed mixed economy with significant private sector was crucial to the maintenance of a democratic politics (Srinivasan , 1988). Chinese leaders were not burdened with excessive concerns with liberal democracy and individual freedoms. Interestingly, both economies assigned a minor role to foreign trade and capital. China did not received any foreign aid until the 1980s whereas, India continued to receive it since the early 1950s. Self reliance in general and technological development in particular, wore important goals in both countries, though these strategies to achieve them were different. In comparison to India, China has succeeded in eliminating abject poverty and achieve impressive gains in life expectancy and other indicators of health and nutrition (Beijing Review, Nov. 2000).

Economic reforms came more abruptly in China (1979) than in India (1991), ranging a decade long gap. Penetrating deep into the economic history of both countries economic reforms in India were

compulsory, under the dictatorship of Fund-Bank duo. Whereas in China, it was the result of the cumulative effects of various socio, economical and political changes. Cultural Revolution was one among them. (Sam, 1999).

In the light of the above discussion we would like to raise certain issues-what is the secret of success of China in its reform process ; where India has gone wrong in its reform; and finally what India can learn from China to fulfill its desired goals.

5.1 Foreign Investment in China between 1979-1990

In 1978, national congress of CPC (Communist Party of China) ushered in a new era in reform, in particular by open door policy, China set itself the goals of transforming the country into a powerful, modern, socialist state by the year 2000 and of quadrupling its GNP. In pursuing these goals, reform of the macro-economic control system and opening to the outside world, have been the most significant instruments. Which in details, are explained below –

- gradual decentralization of planned-economy control system
- encouragement of market forces
- development of forms of ownership other than state and collective
- construction of a new legal system
- opening the economy to foreign capital and trade. China's open door policy, by its by nature, is a policy regarding the degree of freedom of resources, services and exchange of information

across China's boarder, with the issue of foreign investment at the centre. For the Chinese government, foreign investment policy was part of larger strategy which began in the Deng era of seeking out financial support from a variety of foreign sources on the best possible terms. From shortly after the onset of its opening up policy, China found ways to enhance its resources by participating in two key international economic institutions – the World Bank and the IMF.

The general legal principles of China's policy were embodied in the Joint venture Law of July, 1979. Except where law or policy stated otherwise, all foreign investment have been given the same treatment as joint ventures. This joint venture law was a detailed draft of rules and regulations for foreign investors, such as – profit repatriation, selling of product in the market, foreign investment and technology transfer both in terms of scale and sectoral distribution, important export intensity of production, etc.

5.1.1 Economics Results of Foreign Investment Policy (1979-1990)

The Chinese government has used policy and laws to bargain and bluff foreign investors into providing contract terms favourable to China's interests. However, the interests promoted are those of the Chinese state, not always Chinese workers (Bucknell and Kevin 1989). Before I move any further on this account, that the sources available giving details of size and magnitude of foreign capital, are not reliable. Because, sources such as foreign trade almanacs are typically compilations of repeating by provincial and local trade officials trying to throw a rosy light on results. There is no

independent verification, only that by central officials. The second problem with looking at economic results is one of the method. Hobson and Lenin, western academics have been debating whether the effects of foreign investment on underdeveloped countries are benign or harmful. It is highly debatable issue, the opponents of foreign investment, argue on what would have been the case of foreign investment had not been there. Proponents argue that alternative is inefficient socialism or underdeveloped productive capacity (Biersteker and Thomas, 1978). Critics insist that instead of foreign investment, national or local control of production would endure wider distributions of benefits, more indigenous development, and better integration of economic sectors.

5.1.2 Foreign Investment: Its Volume, Distribution and Quality in China

The volume of foreign investment attracted to China has been considerable. From 1979 through 1987, China received about $ 8.47 billion from FDI in more than 4000 joint ventures of various kinds (Beijing Review, 1989). Considering the volume of foreign investment and underdeveloped state of Chinese economy, in per capita terms one of the poorest in the world, this was an achievement. With that effect China became a full fledged competitor with its neighbors for foreign capital (Table-1). China has not only attained a volume of foreign investment that makes it a major competitor with other Asian states, it has also diversified its source of foreign capital. Although, China still depends most on Hong Kong (60%), it has also obtained substantial capital investment from the United States, Japan and

western Europe. In 1986 the proportions stood as indicated in Table 2.

When it comes to the quality and usefulness of foreign investment, there is ideological differences or conflicts among scholars and various schools of thoughts. Does foreign investment displace potential indigenous production, as western neo Marxists charge. Among other critics of foreign investment, MNCs typically buy out local enterprises, especially import substituting ones; use their superiority in scale and technology to compete with local production; and attract skilled workers and managers away from local firms by offering them higher wage scale. All of these above, not only stunt local entrepreneurialism and weaken the potential economic capacities, but also feed poverty and inequality in the host country (see, Chapter 4). But, the proponents of globalization in general and foreign capital, in particular, cite the example of oil industry, the chemical industry, the machine building, the software, the energy and metallurgical industry, which have immensely be fitted from foreign capital (Beijing Review, 1988, 89). The reality is more mixed. One could find examples of productive capacity being greatly enhanced by foreign investment. Neo Marxist concerned about displacement of indigenous production are mostly irrelevant to the Chinese case. Another critical assertion about multinational corporation in poor countries is that they aggravate real income disparity of several kinds: between relatively skilled worker they hike, and the majority they do not employ; between rural and urban areas; between developing and developed region. Foreign capitalism,

gives the argument, uses its superior: resources to offer high wages and make investment in relatively developed areas. This contribute to growth in one limited sector which becomes Increasingly early detached from the nation as a whole. Such a result hinders integrated economic development.

Foreign investment in China justifies some of these critical observation. The most dramatic evidence of unequal distribution concerns differences in investment levels among China regions. These were highly unequal to start with. In 1982, six of China's provinces and state municipalities had a per capita net output produced of 533 to 2490 Yuan, while bottom six all fell between zero and 314 Yuan per year. (World Bank, 1982). Shanghai's ratio of output to population in 1982 was over eight times the level in most of China's provinces and about three times the level of other key cities. In 1985, fourteen coastal cities have only 8 per cent of China's population but account for 23 per cent of the national production (Mu, 1985). This is the evidences that China's industrial production capacity is unequally distributed. Hence foreign investment too was concentrated in regions well qualified with infrastructure facilities and others (Table 3). So far rural urban inequality is concerned, it was noticeable well before reform process was start off. Rural per capita income in 1982 was less than half of urban per capita income, on average (world Bank, 1987). In some provinces the disparity was four to one.

Though, economic reform started in late 1970, but, China's currency was held nonconvertible during this period of reference

(1979-1990). Most manufacturing joint venture through 1985 ran foreign exchange deficits. It was only occasionally that strings of regulations were loosened. For net capital inflows, evidences revealed a mixed picture.

India, in the period of reference 1979-1990, did remarkably well in growth and trade, but in terms of the magnitude of foreign capital, India stands no where when compared with China. Soon after the reform in 1979, foreign capital, particularly FDI, started growing thick and fast in China. The yearly amount of FDI realised in China has passed from one billion at the beginning of the eighties to more than 27 billion in 1990. Whereas India could manage just a few million dollars. India relied heavily on foreign aid and external commercial borrowing. Though these were falling both in magnitude and importance when compared with the earlier periods. The beginning of 1980s, brought about a change in the attitude of government towards foreign capital and trade. The policy of market regulations and state interventions were being replaced by slow but sure liberalization. But in comparison to China, these were different both in quality and quantity. In India, still import and exports were not fully liberalised, there were both qualitative and quantitative controls and foreign capital, too was allowed in certain sectors (power, infrastructure and high-tech industries) whereas others were left untouched. Until the NEP 1991 not much changed in policy formation in India.

5.2 Foreign Investment in China and India During 1990s

The late 1980s, witnessed many politicals and economical ups and downs in China, which further put pressure on the government to redouble its efforts to reform and liberalization. The year 1990 and 1992 stood as two milestones in the development of China's new strategy. In 1990 the opening take place of Pudong in Shangai, a key step in opening the Yangtze corridor, the most important economic belt in the country. In 1992, the former CCP (China's Communist Party) leader Deng Xiaoping made an inspection tour to South China and launched a campaign for further reform and liberalisation, with a vision to establish a socialist market economy. Theoretically and practically, it was a major breakthrough. Since then, a campaign has been sweeping across the entire country to speed of reform and reconstruction (Changzheng, C 1995). This ongoing campaign has finally culminated into its great entry into WTO in 2001. Now economic restructuring has become the Central task (Beijing Review, 2000).

Foreign investment in China is booming, the corporate source of investment is the Chinese Diaspora. In 1994 alone, China attracted $ 33.8 billion in new foreign investment. According to official figures, Hong Kong and Macau accounted for around 70 percent of this, and Taiwan another 8 percent. By comparison, investment from US stands at 7 percent of the total, and from Japan, just 4 percent. Much of the foreign investment in China comes from ethnic Chinese sources. Between 1985 and 1993, foreign Chinese

investment grew from less than 50 per cent of the total to more than 80 percent (Table 4).

Table 5 and 6 give the regional and sectoral distribution of foreign investment in China. It is the Guandong province which attracted the maximum number of enterprise (44705) and foreign investment $ 58.6 billion by the end of 1990, followed by Jiangsu, Shandong, Fujian and Shangai and Shandong with their respective figures of number of enterprises and foreign investment 18082, 12661, 11990, 8050 and $ 10.0 billion, $ 8 billion, $ 11.2 billion , $9.3 billion, Table 6 exhibits that manufacturing sectors attracted the largest number of enterprises (68635) or 81 percent of the total, and t foreign investment too was maximum there, in this sector ($ 44.7 billion or 61.4 percent of the total) between 1979- 1990.

Government priority for foreign investment has been centered in agriculture, infrastructure, communication, energy, transportation and raw material. Foreign investment in finance, foreign trade and service, will also be gradually be introduced and expanded on a trial basis (Beijing review, 2001). To implement the policy governing overseas investment, China will take the following measures.

1. Build a market oriented legal system and provide incentive measures such as favourable tax policy.
2. Financial support in terms of domestic bank loans and mature FDI projects in the above mentioned sectors will received priority treatment.

3. In order to attract foreign investment in projects with long gestation period, the government incentives will involve-high rate of return, tax holidays, in some cases return on projects was buttressed by guarantee.

From the mid 1980s inflows of foreign capital into China have gone up by leaps and bounds, reaching dizzying heights in the 1990s (Table 7). But there was a pause in the wake of the Asian Crises of 1997. The sectoral pattern of FDI has undergone a significant change. Earlier about two-third of the total went into manufacturing, but in 1998 the percentage share came down to 56, while that real estate reached a high of 14 percent, the share of other important sectors are: utilities 6.8, social service (including hotels) 6.5, construction 4.5, transport, telecom etc. 3.6 and trade and food service 2.6 (Table 8). The source of FDI or foreign investment have more or less the same in 1990 as were in 1980s. The new century, started off with recession caused by slowed down global trade and investment, which inturn got its origin in Triad- US, Europe and Japan. The combined GDP of these three core economies accounts for 50 per cent of the world total. Hence, the economic problems of these core economies affect the rest of the world, thus placing the world economy at cross roads.

China's economy grew 7.9 percent in the first half of this year a figure to be proud of, considering the a declining would economy, there are predictions that China will reduce the world economy from economic crises and drive global economy (Beijing Review, September 20, 2001). Whether or not China can lead the world

economy is an interesting question to ponder. But it is true that China's economy remains strong in the face of weak world wide economic growth. What has sustained China's economy is another interesting question to ponder.

5.3 China's Economic Performance: Lesson for India

Since independence, Indian economic history witnessed many ups and downs but the crisis of 1991 was the severest. Indian economy was almost on the brink of a collapse and there was no alternative left, except to go for the stablisation and structural reforms, sponsored by World Bank and IMF. Of all reforms undertaken so far, those dealing India's investment regime have gone through the greatest change. In the organized industrial sector, India had two kinds of investment controls before 1991: regulation of private investment through licensing and reservation of some industries for the public sectors (for more detail see chapter 3). Licenses regulated how much could be invested and where, how much produced, what technology was to be used, etc. Investment licenses, requiring upto e.g eighty permissions, (The Financial Express, Delhi, 5 July 1985), were necessary before an industry could be set up . By late 1998, reforms had abolished investment licensing in organized manufacturing in all but nine industries. Despite the rules governing foreign investment, both direct and portfolio, being dramatically liberalized, foreign investment is never meeting the expectation, particularly when compared with China and other emerging economies.

It is very interesting to look into the reform process in China, which is discussed at length in the last section, which stood China on the forefront of foreign investment in developing countries. What is being wrong with reforms in India and what measure should be adopted to maintain a sustainable level of foreign investment in the desired sectors and India catch up the China's status?

We first consider the case of FDI and see: why is FDI, despite considerable liberalization of policies on the part of India, not coming on a sufficient scale, unlike what is happening in countries like China or even Vietnam. The problem before India right now is not too much FDI, rather the meager flow of FDI is the cause for concern.

FDI depends on a variety of factors, as is seen in the experiences of other successful countries, listed below:

1. Political stability and credibility of reforms – i.e. if FDI policies are reversible, since FDI is a long-term investment decision.
2. State of infrastructure : especially power, transport, communication
3. Policy regime e.g. tariff rates, domestic taxation, restriction on repatriation of profits and capital.
4. Speed and transparency in implementation of government policies.
5. Labour market conditions, particularly labour disciplines, even if wages are low and skills are high in India.

6. Intellectual property right issue: FDI into Indian software industry or any other high tech area (such as pharmaceutical and bio-tech industries) which largely depend on a satisfactory resolution of the IPR issue.

The basic question is: if India wants more foreign investment then it must offer terms comparable to what they can obtain in other countries. In India there is too much emphasis on foreign exchange contribution of FDI to the almost neglect of other benefits such as employment generations, induction of superior technology and better product quality and contribution to tax revenge. Relaxation of the restrictions on the repatriation of profit and capital and greater freedom to exist, greater inflow of FDI may take place.

China is India's biggest competitor as far as FDI is concerned. China is generally perceived to offer a better investment environment in terms of infrastructure, labour discipline, policy implementation, political stability and commitment to economic reforms (particularly in China's Special Economic Zones). Moreover, China started its open door policy towards FDI at least 10 years earlier than India.

China had the advantage of a Hong Kong on its borders from which Chinese businessmen were too willing to relocate factories to mainland China (Hong Kong has become a part of China from 1997) where land and labour cost a fraction of that in Hong Kong. Over 80 per cent of FDI into China is coming from Hong Kong, Taiwan, and overseas Chinese. By contrast, NRIs are mostly professional people with much less involvement in trading and entrepreneurial activities compared to overseas Chinese, they also have less money to invest.

Finally, the labour market conditions prevailing in the special Economic Zones located in Chinese coastal areas such as a regular working day of 10 hours plus two to three hours of compulsory overtime each day over 27 to 30 days per month, an unhindered hiring and firing option for managers and an officially declared policy of offering wages higher than that in the hinterland but not more than 50 per cent of the wage rate in Hong Kong. Which would be extremely difficult to implement in India. Recently, efforts with initiated by government in this regard of 'hiring and firing' of labour but lot of opposition from all spectrum of labour force and opposition in the Parliament.

India should take note of the point that it has to make a proper balance between national interest on sovereignty and more deeper reforms to attract foreign capital, as is being done in China and Vietnam. Although, Capital Account Convertibility (CAC) debate is on, but the recent crises in S.E. Asian countries, Mexico (1994) and Argentina (2001) support 'watch and go slow' on the matter.

Conclusion

Successful economic liberalisation of China, the Giant Economy of Asia can have far reaching implication for the choice of development strategies by other developing countries including India (UNCTAD, 1999). China is attracting more than half of the total foreign capital coming to Asia. The secret behind the success is China itself-its strong political willingness to develop as reflected in its investment

policy (one door-one day clearance policy for foreign investment). The state has got full command over foreign investment both in regard of its sources, sectoral and regional distribution in the country. The trial basis of EPZs in China has turn out to be successful. Infrastructural problems are properly taken care of. There has been no compromise on the fundamental issues-like currency convertibility, labour and capital market control, safeguarding domestic producers, etc.

India on the other hand has just started liberalisation of trade and investment. This reforms of policies was all because of the compulsion and conditions laid down by international financial institutions (WB, IMF and recently WTO). In order to tide over the balance of payment crisis it had to accept the Washington Consensus, promoted and sponsored by IMF. Now, when it comes to the size and performance of foreign capital it stands nowhere near China or other emerging economies of Asia. It should take some lesson from China. Foreign investment with the characteristics-less export but more important intensive, its not reaching in high tech and infrastructure sector, its concentration in metros and big cities, its, posing a threat to consumer goods industry, etc., always does more harm than good for any economy. Similar is the case with India.

In order to attract foreign investment in large volume and in desired sectors and regions India need to change the very fundamentals of its policies (i.e. a proper mix of state regulations and free market). India should come out clearly with its own terms and conditions with MNCs and international financial institutions (Kumar, 1999). It is the time to look back and learn from its past mistakes rather speed away with reforms further.

Table 1

Direct Foreign Investment, 1985

	Total, of which:	Manufacturing
China	US$ 1.96 bn	(unavailable)
Hong Kong	$ 3.21 bn	$ 1.52 bn
Taiwan	$ 701 m	$ 439 m

Sources: Almanac of China's Foreign Economic Relations and Trade, 1986, 702, 743, 1212.

Table 2

Sources Of Real Direct Foreign Investment, 1986

Real	**Proportion of Investment**	**Year's Total**
Hong Kong	US$ 1,132 m	60%
United States	$ 315 m	17%
Japan	$ 201 m	11%
Britain	$ 27 m	1.4%
France	$ 42 m	2.3%
West Germany	$ 19 m	1.0%

Source :Almanac of China's Foreign Economic Relations and Trade, 1987, 619.
Percentages rounded.

Table 3

Distribution of Direct Foreign Investment By Province

(US$ million)

	Direct Foreign Investment Contracts:			
	1983	1984	1985	1985 per capita
Beijing Municipality	29.3 m	119 m	379 m	40.0
Tainjin Municipality	2.14 m	106 m	68.5 m	8.57
Hebei	2.58 m	11.2 m	46.2 m	0.84
Shanxi	--	1.11 m	2.68 m	0.10
Inner Mongolia	2.98 m	2.99 m	5.14m	0.26
Liaoning	17.6 m	44.1 m	254 m	6.95
Jilin	0.75 m	1.37 m	18.1 m	0.79
Heilongjiang	--	5.23 m	30.1 m	0.91
Shanghai Municipality	46.0 m	431 m	771 m	64.00
Jiangsu	3.41 m	56.5 m	118 m	1.91
Zhejiang	7.39 m	31.5 m	45.4 m	1.14
Anhui	--	3.55 m	19.4 m	0.38
Fujian	39.2 m	236 m	377 m	14.10
Jiangxi	--	6.92 m	32.7 m	0.96
Shandong	21.9 m	105 m	100 m	1.31
Henan	0.05 m	5.97 m	70.7 m	0.92
Hubei	--	9.86 m	27.0 m	0.55
Hunan	--	34.6 m	26.0 m	0.47
Guangdong	581 m	1409 m	2198 m	35.65
Guangxi	16.2 m	26.7 m	226 m	5.94
Sichuan	4.57 m	28.9 m	55.7 m	0.55
Guizhou	--	2.88 m	9.78 m	0.33
Yunnan	--	1.51 m	17.5 m	0.52
Shaanxi	10.25 m	1.59 m	407 m	13.72
Gansu	--	0.32 m	4.31 m	0.21
Qinghai	--	23.5 m	0.18 m	0.04
Ningxia	--	3.0 m	2.81 m	0.69
Xinjiang	--	3.29 m	56.45 m	4.20

Note: In most provinces actual investment falls short of "contracted" Investment provided in these Chinese government statistics. Therefore this table is useful only for comparing relative levels in provinces, not for absolute figures.

Sources: Almanac of China's Foreign Economic Relations and Trade, 1984, 1097-8, Ibid., 1071; Ibid., 1986, 702, 1216-1217; Statistical Yearbook of China, 1985, 188, 617.

Table 4

Sources Of Foreign Capital In China (Cumulative 1979-93)

Source Country	Number Of Enterprises	Per Cent	Foreign Investment (Us$ Billions)	Per Cent
Hong Kong	106 769	63.7	47.5	69.1
Taiwan	20 612	12.3	6.4	9.3
Macau	4 188	2.5	1.9	2.8
Singapore	3 037	1.8	1.5	2.2
Thailand	1 361	0.8	0.8	1.2
Sub-Total	136 042	81.2	58.1	84.6
United States	11 554	6.9	3.7	5.4
Japan	7 096	4.2	3.3	4.8
Other	14 314	8.6	4.4	6.4
Total	167 500	100.0	68.7	100.0

Source: State Commercial bureau, FDI in China: Analysis of Trends & Future Directions, 1993, MOFTEC, International Trade News, 16 May 1994.

Table 5
Foreign Investment In China

Number of operating enterprises and capital invested in the top ten recipient provinces, end of 1993

Province	Number of Enterprises	Per cent	Foeign Capital Invested (US$ billions)	Per cent
Guangdong	44 705	26.7	58.6	39.0
Fujian	11 990	7.2	11.2	7.5
Jiangsu	18 082	10.8	10.0	6.7
Shanghai	8 056	4.8	9.3	6.2
Shandong	12 561	7.5	8.0	5.3
Hainan	7 390	4.4	7.8	5.2
Liaoning	7 365	4.3	5.4	3.6
Beijing	6 516	3.9	5.2	3.5
Zhejiang	8 085	4.8	4.4	2.9
Guangxi	4 368	2.6	4.0	2.7
Ten Largest Recipients	129 118	77.1	123.9	82.6
Total for China	167 507	100.0	150.2	100.0

Source: State Commercial Bureau, FDI in China: Analyses of Trends and Future Directions, 1993; MOFTEC, International Trade News, 16 May 1994; State Statistical Bureau, Cina Statistical Yearbook 1994, Beijing, 1995, p. 531.

Table 6

Foreign Investment By Sector, 1979-92

Sector	Number of Enterprises	Per cent	Foreign Investment (US$ billions)	Per cent
Manufacturing	68 638	81.4	44.9	65.4
Public Utilities, Infrastructure and Real Estate	6 908	8.2	16.5	24.0
Restaurants, and Retail Trade	2 436	2.9	1.8	2.7
Agriculture	2 168	2.6	1.4	2.0
Construction	1 571	1.9	1.4	1.5
Telecoms	1 182	1.4	1.2	1.8
Other	1 468	1.7	1.9	2.7
Total	84 371	100.0	68.7	100.0

Source: State Commercial Bureau, FDI in China, Analyses of Trends and Future Directions, 1993.

Table 7

Inflows Of Actual FDI, 1984-1999

($ billion)

Year	Actual FDI Inflows	Year	Actual FDI Inflows
1984	1.3	1992	11.2
1985	1.7	1993	27.5
1986	1.9	1994	33.8
1987	2.3	1995	35.9
1988	3.2	1996	40.2
1989	3.4	1997	44.3
1990	3.5	1998	45.6
1991	4.4	1999 (Jan-July)	19.4

Sources : Up to 1995: SYC 1996.
1996: IFS, BOP 1998,
1997: http://chinaecon.com
1998 and 1999: http://ee.cei.gov.en

Table 8

Foreign Direct Investments By Type Of Enterprises, 1980-99

Total ($ bn)	0.6	6.6	40.4	91.3	45.6	19.4
Of which:						
JV (per cent)	12.8	41.0	37.8	43.5	41.3	34.1
CJV (per cent)	83.8	19.6	40.0	19.5	20.5	17.2
FOE (per cent)	3.4	37.0	13.9	36.9	36.2	47.9
Others (per cent)		2.4	8.3	0.1	2.0	0.7

Notes: JV : equity joint ventures, CJV: co-operative or contracted joint ventures, FOE: Wholly foreign-owned enterprises. * Jan-July 1999.
Data up to 1995 are on contracted FDI; later figures are on actual FDI.

Sources: 1979-90: Chen, Chang and Zhang (1995); 1995: SYC 1996;
1998 and 1999: http://ee.cei.gov.en

Chapter VI

CONCLUSION

Chapter VI

An important focus of this study has been to look at the changing size and nature of foreign capital inflow in India during the last three decades and policy perspective regarding it. In this study of foreign capital, a comparative study of Indian and China has also been made. Since the two shares many commonalities on economic front. From our analysis we find that in the Indian economy during the seventies and eighties, it was the official forms of foreign capital which dominated over its non official counterparts. Further, the study unravels the fact that there remained a huge gap between the authorisation and utilisation of official inflows under all the heads, though the gap narrowed down in the nineties (section A of Chapter III).

Data show a large absolute increase in the inflow of foreign capital in the nineties as compared to earlier period. However in percentage terms it remain as low as 1.5 percent of GDP. The major difference between the capital flows in the 70s and 80s with that of 90s lies in the fact that in the earlier period it was state directed whereas in the 90s state as no control over it rather, it was the interplay of the market forces that quite a big chunk of it is flowing into undesired sectors.

India went in for liberalisation of trade and investment in 1991 because it faced balance of payment crisis. This resulted in its accepting the Fund-Bank conditionalities, consisting of a stabilisation package, privatisation, opening up of trade and capital

account, partial convertibility of rupee, market determined exchange rate, etc.

In the light of this, it becomes essential to look into the areas where foreign capital (especially FDI) is flowing and the forms it is taking. Firstly, of the unofficial inflow of capital, around 68 percent coming in the form of liquid or short term investment and the remaining is long term (Table 1, Chapter IV). Secondly, around three fourth of the FDI goes in mergers and acquisition (M&A) or investment through the secondary market of the stock exchange (Rangarajan, 1998). Three, in contrast to the 70s and 80s, eighty percent of FDI is going in financial collaboration rather than in technical (Table 5, Chapter IV). Fourth, quite a substantial size of long term investment is concentrated in metros or capital cities of the states (Chandra, 1999). Fifth, FDI coming to India is not trade oriented, rather competing with domestic players to capture the local markets (Nayyer, 1996). Sixth, around 80 percent of the foreign collaboration are by big corporations (lying in the range of Rs 100 to Rs. 500 crores of investment) (Economic Survey, 2000). With this picture of foreign investments, specially FDI, in mind, we analysed its impact on growth and development in India.

According to the proponent of foreign capital, liberalisation of trade and foreign investment is expected to stablise price, improve productive efficiency, reduce stress on external balance and generate a momentum in the growth process of the country. All International Financial Institutions are aware of the fact that our country is facing capital crunch for development. Hence, with the provisions of heavy

external debt and its related conditionalities for this purpose, we will bound to encourage foreign direct investment and to some extent portfolio investment.

From the study foreign capital and its impact on economic development, as analysed in chapter IV, it seems no clear consensus. But when analysing Indian case, both the pattern and nature of foreign capital in the last three decades reveal the fact that Indian is loosing more than it is gaining from the inflows of foreign capital.

From 1991, FDI is allowed and invited in consumer products like cosmetics, detergents, soft drinks etc. These products are not essential for the economy as far as they can be easily produced in our country with the help of local resources. Foreign direct investment is catering to the needs of the upper middle and affluent classes and in a big way creating a new "consumer culture" of colas, jams, ice-creams, processed foods and the acquisition of durable consumer goods. Consequently, there is an utter neglect of the wage goods sector. Besides that, the multinationals by investing into production of goods like potato chips, bakery products, food processing, etc. are rapidly displacing labour working in the small scale sector since such units are faced with the stark prospect of closure, being unable to compete with MNCs. Thus both from the point of the patterns of productions and employment, the unrestricted entry of multinationals in soft areas has dangerous implications and its encouragement will not be helpful for the faster economic development of India (Kumar, 1997).

With the acceptance of IMF and WTO conditionalities, step by step, we are opening up the economy and bringing new sectors – service and agriculture, to the ambit of foreign investment. But, these investments are not generating employment to our needs. Hence in the near future, employment generation would be more challenging (Fadnavis, 1998).

An interesting thing about the operation of MNCs (or FDI) in India is that they have raised a major part of investment resources from within the Indian economy (Choudhary, 1979). Foreign resources (in the form of foreign share capital and foreign loans) contributed only 5.4 percent of the financial resources of these companies, 94.6 percent was contributed by the domestic resources. This fact about the financing behaviour of MNCs explodes the myth that they bring large amount of foreign capital with them. The real position is that MNCs collect most of the capital from within the country itself but repatriate large amounts of the profits to their home countries.

MNCs in the name of FDI inflict heavy damage on the host country in various forms such as suppression of domestic entrepreneurship, extension of oligopolistic practices (such as unnecessary product differentiation, heavy advertising, etc.), supplying the economy with unsuitable technology and unsuitable products, worsening of income distribution by distorting the production structure to meet the requirements of high income elites, etc (Kumar, 1992 and Chandra, 1991). Foreign investment through

MNCs, opens up the door for "neo imperialism" and "exploitation" (Baran, 1964).

The government of underdeveloped countries also felt threatened by direct and indirect interference of foreign capital inflows (particularly by MNCs) in their internal affairs. The autonomy and sovereignty of the host countries is in danger (For example the political instability in Indonesia).

Indian entrepreneurs seem to have lost their bargaining power and well known Indian brands have been taken over by TNCs (for example, Whirlpool took over TVS Whirlpool, Peugeot took over two of the plants of Premier Automobiles, Hindustan lever took over TOMCO, and the list goes on). It needs to be emphasised that take over do not add to new production capacities, on the contrary, they are likely to add to higher outflows of foreign exchanges.

Around 67 percent of the foreign investment is in the nature of portfolio investment (see Table 1, Chapter II), which only strengthens speculative trading in shares. This has led to an artificial boom in the share market, and when this boom burst, the market came tumbling down and millions of small shareholders who entered the share market to have a quick buck, suffered very heavy losses, but the big sharks were able to manipulate the market to corner big gains from them. Quite often, these securities boom resulted in scam, involving millions of rupees (for example Harshad Mehta, Kirit Parekh and recently Ketan Parekh). Portfolio investment made in India in nature of hot money which may take to flight if the market

signal indicates any adverse trend. Thus it would be mistaken to treat portfolio investment as a stable factor in our growth.

Absorption and development of technology is critical for higher economic growth in India. FDI through TNCs are unlikely to develop technology in India. They will simply imported where need it (Kumar, 1999). Hence with no technological development through FDI and the following domestic investment on research and development indicate toward perpetual technological backwardness in India. Which may threaten the country's independence.

90 percent of FDI in India is flowing in 6 industries including pharmaceutical, power, metal and metal products, telecommunication, etc. There are three disadvantage associated with it; one, these industries are more import and less export intensive; two, they are less labour intensive, three, most important among all, they are not environment friendly.

Even if TNCs do not bring much fresh capital and technology, they can control large chunks of Indian output and capital. The largest of the Indian capital is tiny by TNC standard. Large outflow of capital is taking place, registered or unregistered from the country. Employment generation would suffer greatly. The top 20 of TNCs in Fortune 500 list produce an output 6 times larger than Indian's GDP but they use a workforce which is only 7 percent of India's (Citizen Union Budget, 1994-95).

Higher FDI in the economy also demand for the entry of FIIs (Foreign Institutional Investment) and higher FIIs in turn brings

more speculation and instability in the stock market and finally, result in unproductive investment and lower employment generation.

So for in the Indian economy FDI is treated with micro analysis i.e. its relationship with employment, domestic investment, technology transfer, etc., separately. It is the time to give an overview to FDI and its socio-economic and political issues. Only after this policy formulation should be initiated, taking into account the national considerations.

In India, due to the rising share of the black economy or parallel economy, the policy maker loses control over the flow of capital within the economy and the leakage outside. Further, rising black economy weakens the capital base in India and strengthen further our dependency on the foreign capital. But, in China, being highly state regulated, capital outflows does not pose any threat to the country (Kumar, 1999).

In contrast to India, China's example, among other emerging economies of the world, is usually cited as the successful gainer of foreign investment. As discussed in Section A of Chapter IV, it becomes amply clear that China has never compromised with its foreign investment policy and the move towards economic reform in 1979, was the result of the cumulative effects of many socio-economic and political factors, rather than any international pressure. China along with providing necessary inputs and infrastructure facilities, did not deregulate the strategic areas to invite foreign capital. These include domestic currency was not made convertible, foreign investment was allowed in export oriented units

(for example EPZs) rather than to produce for domestic market, small scale industries were duly protected, etc.

Of course, the role of non resident Chinese in Indonesia, Malaysia, Taiwan, Macau, Hong Kong etc. can not be undermined, whose spectacular contribution to the foreign investment, gave China a new look. Today's China is not only the second largest (after USA) country to attract foreign capital but also seems to save the world economy plunging into a severe economic crisis, because of its remarkably sustained high growth despite the crisis world over (the Economist, Feb 2-8, 2002).

In sum, the impact of foreign capital inflows on the economic development of a country goes, both way. While some countries have gained but the others have failed to extract the best possible out of foreign capital inflows. As far as India is concerned it has a bitter experience with foreign capital in the reference period. Though small insights with its many socio-economic and political implications foreign capital (especially FDI) is adversely affecting the development prospects of India, to a great extent. This situation became more alarming with the opening of the economy.

A comparative study of foreign capital inflows in 1990s with the earlier two decades, in Chapter II and Chapter III, gives some interesting results. One, foreign capital inflows largely of official form during the 70s and 80s was directed by the state in the priority areas, whereas, during the 90s, it was directed by the market forces. Second, foreign capital inflows has given rise to capital flight abroad (through black economy), in both the periods of reference. But in the

90s the size of black economy expanded even further (40 percent of GDP in 1995). Also, because of growing size of black economy, we are forced to tie unfavourable terms and conditions with MNCs and to give them entry in undesired sectors in the economy. Three, Indian industrial class was lacking in vision to develop their own technological base rather depended heavily on the imported technology during the 70s and 80s. Now in 1990s also with the most of PSUs are being privatised and retaining the same vision as before our business class are being subjugated by MNCs. The technological base in India is weakening vis-à-vis the advanced country. This will adversely affect the generation in India.

China's big success marks towards the lessons that India can learn in order to make the best use of the foreign capital. Two factors, which seems to be non existent in India, gave China a big push forward in terms of foreign capital right from the very beginning of reforms. These are, strategic Sino-US alliance against the erstwhile USSR and the eagerness of Chinese capitalists in Hong Kong, Macau, Taiwan, and elsewhere in South-East Asia to relocate in China, as labour became too expensive in the home countries (Chandra, 1999). With the disappearance of the USSR, the US is unlikely to need any other special ally from the developing countries and will not offer anew kind of market access as provided to China. The spectacular role of non- resident Chinese as seen above (Chapter V), in transforming the economy into an Asian giant.

Hardly less important than these extraneous factors are the level of all round development achieved during the first three

decades of over centralised planning, the heavy industrial base, commendable success in attaining in health and education and the dominant role played by the state. The kind of role given to market was well within the defined parameter by the state.

Among the others, India cannot hope to get such large inflow of FDI as China did into export oriented units nor India can likely to accumulate like China in large stock of outward FDI, which was a key factor in the architecture of Deng's open door policies (Chandra, 1999). India with a potential of high exports are groaning today under the external dent burden (for example in 2000-01, it crossed $100 billion mark) with its fiscal, monitoring, industrial and financial sector being closely monitored and shaped by the IMF, World Bank and WTO, which is a stark attack on the economic sovereignty of the country.

Nevertheless to all these, India can learn from China, how to manage foreign capital. In this regard, a simple *laissez faire* policy may not be the best way to attract them. CAC (Capital Account Convertibility), which India rapidly moving to, is likely to invade the most profitable sectors displacing domestic capital, and avoid those where domestic enterprises and capabilities are deficient. It is required, some strategic restraints on both the sectoral and regional contribution of foreign capital in India, as in China was.

Yet in era of stiff competitions among developing countries to attract export oriented FDI, liberalisation of policy alone may not be enough to win the race. More active negotiation and bargaining with MNCs may often be required. India should use its bargaining

advantages such as large domestic market, abundant supply of trained and low wage labour, vast pool of technical professionals, well developed capital market, etc. more effectively to attract proportions of efficiency seeking FDI (Kumar, 1995).

In sum, researches are carried on to make a trade off between open door policy and strategic state intervention. In India it is the time to take a pause in the ongoing reform process and learn from its past mistakes and make corrective measures wherever necessary. Hence, 'reform the reforms', should be the next step to make the efficient use of foreign capital and sustaining for long.

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