FOREIGN CAPITAL

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"Free Enterprise was born with man and shall survive as long as man survives".

-**A.D. Shroff**
1899-1965
Founder-President
Forum of Free Enterprise

FOREIGN CAPITAL

By

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The opening up of the economy to foreign capital has been an important component of the New Industrial Policy of 1991. The subject has, indeed, generated considerable interest both in India and abroad. The most recent interest has been evident at the World Economic Forum's Europe-East Asian Economic Summit on 22nd September 1995.

The topic of foreign capital is extremely sensitive to our country because of our long period of colonial history and our preference for external aid instead of investment flows in successive plans. It is important to appreciate the right perception about foreign capital especially when India has embarked on the globalisation path.

Foreign Capital is important for India to boost its growth from 5 to 6% p.a. at present to over 7 to 8%. First and foremost, foreign capital is required to finance India's widening savings investment gap especially in infrastructure. Infrastructure development is crucial to sustain India's accelerated progress. According to our Finance Minister, India's investment need is likely to be

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at least $ 200 billion over the next ten years to be used in roads, telecommunications, energy and railways. India's investment in the infrastructure sector is 6% of the GDP. This is aimed to increase to 10% for achieving an accelerated growth. Further, foreign capital is essential to modernise industry and strengthen its technological base. By inducting marketing and managerial skills and generating exports it can usher a sustained move towards a viable Balance of Payments. In short, foreign capital is essential not only to bridge the savings investment gap but also for improving international competitiveness and reorienting the work culture.

Only two years back it was China first and then India for foreign investment. At present both China and India are fancied by overseas investors. At the just concluded Europe/East Asia Summit it was averred that India and China could both be equally attractive sites for East Asian investment and that the two Big Emerging Markets could evolve a relationship of competition and cooperation.

After over four decades of experimentation with the public sector to deliver the goods, the centre gave up its Policy of commanding heights for the public sector in mid 1991. The list of industries for automatic approval of 51% foreign equity and foreign technology agreement has been steadily expanding to embrace metallurgical industries, fertilisers, transportation, chemicals, drugs and pharmaceuticals, paper, automotive tyres and tubes and electronic software etc.

Two important policies

- New Industrial Policy of 1991 welcoming foreign majority equity participation in 34 high priority industries

- Amendment of Foreign Exchange Regulation Act

provided the most important boost to foreign capital. These were supported by a number of reforms like rationalisation in tariff structure, liberalisation of imports, convertibility of the Rupee on the Current Account, financial sector reforms, dilution of MRTP, reforms in the industrial licensing system, single window clearance for FDI upto 51% in several industries, Euro Issue guidelines, FII directives etc.

Apart from liberalisation, in general, and streamlining of procedural framework, special policy packages for foreign capital in key sectors like power, telecommunications, roads, hydrocarbons, food processing, tourism etc. are evolving.

The economic liberalisation has paved the way for two important developments. Indian companies have started raising funds abroad through the mechanism of Global Depository Receipts (GDRs). The number of such companies now exceeds 50. Some of the prominent names are Reliance, Grasim, Bombay Dyeing, ITC, Larsen & Toubro, Mahindra & Mahindra and Gujarat Ambuja Cements. The other development has been the flow of foreign investment into India, both Direct and Portfolio. The Statement on Industrial Policy of July 1991 and subsequent announcements have amply made clear

that there is no restriction whatsoever on the level of foreign equity holdings in sectors eligible for foreign investors.

Approvals of Direct Foreign Investment have been growing with each passing year since 1991 from Rs.5.3 bn to Rs.118.6 bn in 1994 and have aggregated to Rs.397.5 bn in the post liberalisation period (August 1991 to October 1995).

Actual inflows of foreign investment constitute roughly 28% of approved investment during this period. There has been concentration of investments in large sized projects, particularly core industries, where gestation period is high and consequently, projects take time to fructify.

FDI approvals and actuals have not declined as apprehended following the review of some major projects by newly elected State Governments. FDI approvals during January-June 1995 were 78% of total FDI approvals for the entire 1995 and were nearly thrice the approvals in the corresponding period of the previous year. Similarly, actual FDI investment during the same period amounted to over thrice the actual investment during the corresponding period of 1994 and was 17% higher than the inflow recorded in the entire 1994.

Actual Foreign Direct Investment in the economy is rising. The ratio of Actual to Approvals is up from 17.4% in 1992 to 20.2% in 1993 and 23.2% in 1994. Since inflows typically materialise after a lag, the trend recorded in 1995 is likely to continue. India is expecting a flow of $ 3 bn to $ 5 bn in the next few years.

The share of NRIs in total FDI is over 30%. If Sodhani Committee recommendations on NRI investments get fully implemented then probably NRIs may replicate Chinese overseas investors' experience. According to the Industry Ministry, actual FDI of NRIs inflow in first six months of 1995 exceeds inflows recorded for the whole of 1994.

Industry-wise breakup of FDI inflows since August 1991 to June 1995 indicates that the bulk of foreign investment so far has been in the priority sector. Investment intentions are mainly in fuels (23%), including power (10.2%) and oil (10.9%), metallurgical industries (12.2), chemicals (8.5%), services (7.9%), electrical equipment (6.7%), food processing (6.2%), transportation (5.3%), hotels and tourism (5.2%) and textiles (4.1%). Power, telecommunications, electronics, oils, food processing, mining, roads and highways, ports and shipping, tourism and automobiles present tremendous opportunities for foreign investment in the coming years.

Over half of the foreign investment approved is concentrated in the four states -- Maharashtra, Delhi, Tamil Nadu and West Bengal. A distinct preference is for industralised states having a well developed infrastructure and which are politically stable. Recently States have become aggressive in wooing foreign investment. This will make States eventually independent of the Centre in economic policy making.

Major investing countries are the US (30.5%), UK (6.9%), Japan (4.2%), Switzerland (3.9%) and Germany (3%).

Though India has advantages of a huge market size, cheap labour, technical and managerial talent, well diversified industrial base, favourable repatriation policy, certain deterrents to FDI do exist. These are a high tax structure, poor labour relations, weak infrastructure, inadequate legal and regulatory framework, bureaucratic culture and inadequate protection of IPR.

The objectives of recently revised guidelines for Joint Ventures/Wholly Owned Subsidiaries abroad include providing Indian Industry access to foreign networks and market. It would encourage Indian industry to improve its image abroad through self regulation. Corporates will now be allowed to raise GDRs to fund mega joint ventures or wholly owned subsidiaries abroad which cost more than $ 15 million. This is the single biggest boost to globalisation efforts of Indian corporates. These guidelines will promote the creation of Indian Multinational Corporations. True globalisation implies not only the country opening its doors to foreign multinationals but also Indian companies going global. The emergence of trade blocs has necessitated a much greater presence of Indian companies abroad. The onus is now on the corporates to raise a substantial portion of the required foreign exchange resources on their own or earning foreign exchange through increased exports.

India has also started entering into Bilateral Investment Treaties (BIT) with foreign countries. If a Bilateral Investment Protection Treaty had been signed between USA and India, may be the Enron controversy may not

have taken the present turn. Britain, Germany, France and Italy have entered into guarantee pacts with India which has helped in boosting investor's confidence.

BITs are a rather recent phenomenon on the global investment scene. These seek to create legal frameworks under which investments made by nationals of the treaty parties in each of these countries are protected. The need for such treaties arises because there are no internationally agreed standards for protection of foreign investment.

Major multinationals operating in India are setting up wholly owned subsidiaries to undertake new profitable businessess rather than route it through their existing affiliates or subsidiaries in which Indian investors are minority shareholders.

Venture Capital Companies are now allowed 100% foreign stake.

The automobile sector till now dominated by a few players was content with limited models to choose from. However, all is changing and what is about to happen is likely to dwarf the sea-change that has already taken place. (Tie ups between Hindustan Motors and General Motors of the USA, Premier Automobiles with Peugeot of France, TELCO with Mercedes Benz of Germany, DCM Toyota with Daewoo of South Korea and Sipani Automobile with Rover of UK).

Changes have started taking place in the road transport sector. Amendment in the National Highway Act has been

made. Further, the road sector has been accorded the status of an industry to facilitate borrowings on easy terms and to float bonds. India has two million km of roads though the quality of roads varies. Similarly Power, Telecommunications and Ports sectors are getting transformed.

Thus, Privatisation drive in the Indian economy has already begun though its pace is slow. This is significant as it shows the determination of the government to loosen the grip of the Public Sector on the economy. In short, the face of the Indian economy is changing. In a brief span of four years since mid 1991, irrespective of whatever the problems the economy faces today, the Public Sector has declined in its importance. Today, only few industries -- atomic energy, coal and lignite and mineral oils are reserved for the Public Sector.

Of late there has been a qualitative shift in favour of DFI as compared to portfolio investment.

Foreign Investment Inflows

	1994-95	**1993-94** ($ mn)
Direct Investment	1,314	620
Portfolio Investment	3,581	3,490
Total	**4,895**	**4,110**

However, regardless of Enron, Foreign Portfolio Funds have continued to pour in. Even at present with political uncertainty, FIIs have adopted a wait and watch attitude. More efficient capital markets can rope in foreign capital

even more. Compared to a figure of Rs.3.6 billion in June 1995, net inflows in July were Rs.6.5 billion, the highest levels since last October. The crucial bottleneck in Portfolio Flows lie in archaic and inefficient settlement procedures, an inadequate forward trading mechanism and illiquidity problems.

The sentiment towards Indian GDR paper was not very positive in the beginning due to a number of factors, both domestic and international. By the end of February the GDR market more than recovered signifying international investor confidence in India.

The domestic counterparts of these GDRs, however, at times have been following a lower trajectory. The fundamentals are good and this downtrend is only a reflection of scarce liquidity conditions and political uncertainties.

A survey of foreign fund managers reported by a recent issue of FT found that FIIs would be prepared to invest $ 10 billion a year in India. The only thing holding them back is poor liquidity and dodgy cumbersome settlement process.

The recent promulgation of Depositories Ordinance is a positive development and marks the next phase of capital market reforms. It is likely to result in higher capital inflows. The depository arrangements will be made in phases only so as to facilitate an orderly switchover from the existing system towards a scripless trading in stock market.

Another development in Portfolio Funds is the government's decision to take PSU shares to world

market. In this year's Budget the Finance Minister has earmarked Rs.70 billion to be raised through PSU disinvestment. Overseas Corporate Bodies, Non Resident Indians, and Foreign Institutional Investors can subscribe to PSU shares.

External Commercial Borrowings as % of total borrowings increased from 10.9% in 1980-81 to 31.8% in 1989-90 and then fell to 9.1% in 1993-94 due to strict controls. The issue is one of devising some kind of mechanism so that the country's external debt does not get out of control. Can differential treatment be given to debt which is a legacy of the past and the new debt i.e. fresh external borrowings?

Foreign Capital and Balance of Payments Scenario since 1991 to date :

STRIKING HIGHLIGHTS

1. Contrary to expectations, exports growth has started showing buoyancy (18 to 20%)

2. Imports are rising at a higher rate than exports but it is a healthy growth.

3. Net Remittances, again contrary to expections, have buoyed thereby making the Balance of Payments scenario more resilient.

4. Current Account Deficit at $ 2082 million in 1994-95 (0.7% of GDP) has been contained due to export buoyancy and net remittances.

5. Equity Related Capital inflows have been exceptionally large during 1993-94 and 1994-95 ($ 4 to 5 billion).

6. Actual FDI is rising which is once again a healthy development. FII investment which rose exceptionally high in 1993-94 continues to rise and at end August 1995 cumulatively amounted to $ 3.8 billion.

7. While in 1993-94 Portfolio Investments rose by a greater margin as compared to DFI, during 1994-95 it was the other way around.

8. Total capital inflows amounted to $ 10 billion in 1993-94 and $ 8 billion in 1994-95. Capital inflows net of Rupee debt servicing amounted to $ 9 billion and $ 7 billion.

9. Foreign Exchange Reserves were $ 15 billion at end 1993-94 and $ 21 billion at end 1994-95. These have now come down to $ 17.4 billion.

Crucial Issues in Foreign Capital currently debated are:

a) Discrimination against Indian Industry :

Quite often compalints are voiced that Indian industry and institutional investors are discriminated against as compared to Foreign Industry and institutional investors. Broadly these discriminations can be grouped under the following :

i) Non Tariff barriers are imposed by developed countries from time to time on grounds of child labour, human rights, environmental hazards etc. As a result, Indian exports have suffered. These forms of protectionism are at times given the garb of humanitarian concerns. Unlike the Asian Tigers which could prosper through export led growth in the 1970s because of the favourable international environment, in case of India, because of increasing non tariff barriers, the going may be tough in the future.

ii) Indian industry suffers from certain handicaps. These relate to high interest rates, complex tax structure, lack of the state of the art technology, a labyrinthine bureaucracy and elaborate administrative procedures. Other handicaps are lack of exit policy and anti dumping duties taking an extremely long time and at times not being decided in the right spirit at all.

iii) Government policy stand at times is tilted towards favouring foreign industry and foreign institutional investors more than the domestic Industry and domestic investors.

b) Is Foreign Capital inflationary?

Whether induction of any capital is inflationary or not depends on its end use. Capital used for speculative gains may have inflationary effects though it may improve the liquidity situation in the short run. Capital used for productive purpose will eventually reduce inflation. Normally DFI is taken to be non inflationary and FII

investment as inflationary. Both can be inflationary or non inflationary depending on their end use.

c) Is Foreign Capital a substitute for domestic savings?

The fact that incremental domestic capital formation is negligible underscores inadequacy of domestic savings. Foreign Capital can supplement domestic savings. On the surface it seems the sum that is repatriated back makes a hole in the country's savings. But no foreign capital is likely to come without some cost. Foreign Capital does not mean money alone but also technology, accountancy, new systems etc. In other words Foreign Capital includes both financial investment as well as industrial investment. India at present is dependent on foreign savings to the extent of 2% of total savings. This percentage may increase in future with free flow of funds to about 6-7% level.

d) Impact on the Rupee

Rupee at present has steadied to a level of Rs.34.5 - 34.9 a dollar from Rs.31.37 which was maintained for about two years. The Rupee is likely to be around 35-36 by March. During last about two months, the trend in the exchange market has been that of a persistent weakness against the dollar unlike 1994-95, when the anxieties of the government, the RBI and the exporting community related to a possible appreciation of the rupee consequent on the large inflows of foreign investments, particularly in the portfolio segment.

The issue is whether the weakness of the Rupee will affect the Portfolio Inflows. Some depreciation of the rupee might not scare the FIIs as FIIs usually factor in a depreciation of 4-5% in local currency while investing in emerging markets. According to an FII, India still remains a good market to invest in and only those who are looking for an excuse for not investing in the country will cite the rupee fall as a reason to pull out.

India's potential as an investment Eldorado is established. The Finance Minister announced two initiatives at the Asean India Round Table in Singapore which he would like to implement if he is elected back in office -- the lowering of tariffs at par with Asean levels and the tightening of arbitration laws to safeguard the interests of foreign investors. The Finance Minister also assured the setting up of a regulatory body as a prelude to the liberalisation of the insurance sector.

Some policy changes are inevitable when India is traversing an unchartered path. But revisions are happening too often in fields of GDRs, Power etc. These are in turn delaying the fructification of the results of the Reform Process. Apart from revisions, ad hocism in formulating policies is noticeable. As, in the current year, there has been depletion of Foreign Exchange Reserves to the extent of over $ 2 bn so far; the Government has lately started formulating policies that would bring in more foreign exchange. (Fresh set of policy guidelines for overseas and domestic venture Capital Funds and relaxation for ECBs by 100% EOUs). At times the

measures adopted smack of ad hocism which should be avoided. Long term policy should be clearly spelt out and within the perspective of long term policy, the short term policy should be formulated keeping short term economic scenario in view.

The growing fiscal deficit if not controlled can affect the flow of foreign capital.

India requires a diversified trade strategy to minimize the danger of non tariff barriers. Also its anti dumping laws and procedures require to be further streamlined.

According to a recent UNCTAD (United Nations Conference on Trade & Development) Study international competition for FDI with fiscal, financial and other incentives is intense. Hence for attracting more foreign investment, reforms require to be speeded up. Corporate taxes have to be reduced to international standards, state level taxes need to be harmonised and pegged at reasonable levels, revisions and rationalisation of Company Act are required, system of Government clearances at various levels has to be expedited, greater transparency in the policy package for private and foreign investments in the infrastructure sectors supported with adequate fiscal incentives.

Though foreign capital is urgently required, but the problems of infrastructure could not be left to foreign investment alone for solutions. Foreign Capital could only provide a temporary growth and we have to set our house

in order through efficient functioning. For e.g. in case of power, SEBs have to become efficient.

India and China rank high as Big Emerging Markets on US agenda. US considers itself a part of both Asia and Europe and this is the reason why US Under Secretary for International Trade attended the Europe/East Asia Summit in Singapore. Asia, Europe and America need one another to overcome their weaknesses and realise their strengths.

Though the Indian economy has come a long way it would be unwise to read much at this stage. The signpost is not the destination. Only a few tentative steps have been taken and a long road still lies ahead. There are also dangers along the way as the Enron Project controversy has demonstrated. Also seen in the global context, the flow of funds into India is still small relative to China. Some improvement is discernible of late but more is urgently needed considering the scale of resources needed in the infrastructure areas and other major industries.

In the final reckoning, only two cheers for the new economy policy initiatives, the third is due when they acquire an irreversible momentum and lead the country to a high plateau of growth and employment.

(The views expressed in this booklet are not necessarily those of the Forum of Free Enterprise)

"People must come to accept private enterprise not as a necessary evil, but as an affirmative good".

-Eugene Black

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FORUM OF FREE ENTERPRISE

The Forum of Free Enterprise is a non-political and non-partisan organisation started in 1956, to educate public opinion in India on free enterprise and its close relationship with the democratic way of life. The Forum seeks to stimulate public thinking on vital economic problems of the day through booklets and leaflets, meetings, essay competitions and other means as befit a democratic society.

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