# INTERNATIONAL FINANCE FOR DEVELOPMENT — A STRATEGY FOR INDIA

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By

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It is a privilege for me to be associated with honouring the memory of an illustrious businessman like the late Mr. A. D. Shroff. Apart from his outstanding contributions to business and to national and international economic strategy, he transmitted his abiding faith in the private enterprise system through the organisation which is honouring his memory this evening.

The world is passing through an economic abyss the like of which it has not known for the last 50 years. Even the most advanced economies are under severe strain. Unemployment of about 10% of working population is almost a norm with 30 million unemployed in the OECD countries alone. In countries like the USA, UK, Holland, etc. one in 7 employable people are unemployed. Interest rates well above inflation rates continue to depress economic activity while Governments experiment with fiscal and monetary policies in their attempts to reduce inflation and revive their economies. Bankruptcies and threats of bankruptcies and defaults

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abound among sovereign countries in debt like Poland ($25 billion), Argentina ($40 billion) and Mexico ($80 billion) and among international companies like Dome Petroleum of Canada, International Harvester of USA and AEG of Germany. The end of this trail of doom and disaster is not yet in sight.

On the other hand, unlike the 1930s, the world economic order today has many interdependent professionally managed organisations like the IMF, and the World Bank, and some political leaders who can take a more global view. Therefore, no one expects a total collapse or Great Depression ahead. But there will be a greater preoccupation with domestic economies in almost all the Western countries. Yet, while the world stagnates and stumbles, India can and should continue to plan boldly and realistically for further growth and stability. Therefore, I have chosen for the topic for this Memorial Lecture "International Finance for Development — A Strategy for India". As I am involved in international business, my perspective will tend to be more that of a businessman than that of an academic or a politician. It will also be that of an Indian who believes more than ever before in the international investment of private capital. I proffer no apologies for it. Perhaps it is time that more businessmen were invited to participate in the evaluation of the nation's economic strategy as they were at the time of the Bombay Plan with which Mr. J. R. D. Tata and Mr. Shroff were intimately involved.

## The World Economic Scene

During the last two years, the world economy has decelerated markedly. From an annual growth rate of just over 4% in the decade of the 1970s, the growth rate of world gross domestic product dropped to 2% in 1980 and 1.12% in 1981 according to the current World Economic Survey of the United Nations. (See Chart I—*Source:* World Economic Survey—United Nations.)

In the developed market economies, this decline in annual growth rate was from 3.4% in the 1970s to 1.5% in 1980 and 1.2% in 1981. In the developing countries, it dropped from 5.6% in the 1970s to 2.9% in 1980 and then again precipitously to as low as 0.6% in 1981. One serious implication is that in the developing countries where population growth rate is well above 2% per annum there has been an actual fall in per capita GDP during 1981. This has happened for the first time in the last 25 years and it has implications not only in current consumption but also in their ability to invest for growth.

It is commonly believed that this sharp decline in world economy in 1980 was a sudden phenomenon related solely to the increase in petroleum prices. Whilst undoubtedly this has been the major factor, the relevant figures for the last 20 years indicate that there has been a declining trend in the world economy starting from the late 1960s. (See Chart II—*Source:* World Economic Survey—United Nations.)

It shows that the slowdown started in the late 1960s with the developed market economies; it spread to the centrally planned economies and even to the developing countries by the second half of the 1970s. It will be worthwhile understanding the causes of this decline because if the causes are irreversible and the decline is to be a lasting trend, it will have serious implications for developing countries like India, who are affected by the realities of the world economy.

To place the decline of the world economy through the 1970s in perspective, it is well to remember that the high growth rates of the 1950s and 1960s were the result of impetus of post-war recovery, sprint in technology, low cost energy and the liberalisation of trade. Some of the factors that contributed to the subsequent decline were:

(i) the growth of the welfare states and military power in several countries diverting more of the surplus to provide social security and defence rather than to investment;

(ii) investments in and protection of inefficient and uncompetitive industries for social reasons;

(iii) the deceleration of improvements in productivity due to impediments to innovation;

(iv) the tremendous increase in energy costs from $1 per barrel to over $30 per barrel in the 1970s; and

(v) the erosion caused by the resultant inflation.

The world is now witnessing the results of attempts by some of the major economies led by USA to restructure themselves out of this decline. The outcome of these attempts will determine the future of all economies including ours. We will probably not know the results till 1984, because the changes in fiscal and monetary policies have to work their way through. But the determination, tempered by flexibility, which has been shown by leaders in the Western world in dealing with their key domestic economies, should lead to a resumption of economic growth. The control of rates of inflation in USA and the lowering of interest rates there could well herald the beginnings of more investment which could lead to recovery in USA during 1983. The rolling back of public sector and Government expenditure is now a reality in most countries.

Simultaneously there is a great effort being made by private industry in the Western world to improve its own productivity and innovative capacity. Therefore whilst we have not yet seen any significant upturn and we still have several economies on the critical list of patients, it is possible to say that the major economies are under treatment and as the response to the policies take effect the world economy might stage a recovery to about 2-3% growth rate by 1984. Any strategy for the Indian economy will have to be based on this hopeful but not optimistic outlook for the global economy.

## Indian Economy and its Needs

If one looks at the evolution of the Indian economy over the last 30 years, one can discern three distinct phases. The first is best termed the phase of 'Initiation'—of plans, projects and philosophies. This was a glorious phase of excitement and honeymoon with the world that lasted till mid 1960s. The second phase could best be termed as the phase of 'Introversion'. The honeymoon with the world was over and a severe dose of 'self sufficiency' was administered which almost led to a form of economic narcissism. This lasted till the mid 1970s. Then came the third phase of what could best be termed as 'Isolation' which naturally resulted from introversion. The deceleration in world economy from the late 1970s had coincided with our period of Isolation which, to some extent, has conditioned all responses and attitudes.

But now at the end of the 30 years, the combination of the difficult world economic scene and the pressures for necessary growth in the domestic economy seem to have made it necessary for India to re-examine policies and attitudes. The economic strategy presented to the IMF in 1981 certainly indicates this. Therefore one could reasonably hope that we are coming out of 'Isolation' into a new phase of 'Innovation' in economic strategy. It is high time for us to enter an innovative phase in economic strategy and to shake off some of the philosophies and attitudes imbibed from theoreticians who continue to live in our period of Introversion. Innovation is the result of applying upto-date knowledge to practical problems by those who have some urge to seek change and improvement. The ideas that I shall be putting forward tonight are meant to be a contribution to this Innovative phase which I hope is taking shape now.

Any economic strategy has to be based on a consistent and compatible political philosophy. Although I am not dealing with politics in this talk, one notable feature of Indian politics is that fortunately it is still in a state of flux as far as political philosophies are concerned. There are no rigid positions except the rightful concern for the less privileged and hence the urge for development which is primarily for their uplift. This could provide a potentially stable base for economic strategy.

Harnessing of resources and investing them for equitable growth are the prime components of any economic strategy. To evolve such a strategy one has to be clear about objectives as well as the constraints and opportunities available. During the next decade if we were to attempt to double our per capita income, it would require a 9% per annum growth in GDP after allowing for a 2% per annum population increase. The modestness of this target can be appreciated if we compare India at the end of that process with other countries. We will still be in the same league as Sudan, Kenya and Indonesia. We will have reached only one third of the per capita GDP level of Malaysia or a quarter of that in Brazil and only 5% of the US per capita GDP. So it is a very modest level to aim for. But even this requires a doubling of our historic rate of growth.

It is not as difficult as it appears provided we have a sound, and more important, a consistent investment policy. The two factors to be improved are the capital:output ratio and the quantum of investment capital; and there is ample scope to improve both these.

## Improving the Capital : Output Ratio

World Bank's estimates of average Capital : Output ratio in India for the period 1960-61 to 1979-80 are given in Chart III.

The trend has been clearly damaging. Capital : Output ratio deteriorated from about 2.5 to 3.3 during this period. In other words, for an input of capital of 100, the value of output dropped from 40 to 30, a decline of 25% in efficiency of using capital during the last 20 years.

It can be estimated that if the Indian Capital : Output ratio remained at 3.3, the rate of investment and savings required in the economy to achieve a 9% per annum growth in GDP will be over 30% per annum of GDP which is an unrealistic target. If the capital : output ratio is restored to the earlier level of 2.5, the rate of savings required to achieve a 9% per annum growth in the economy would be only about 21% of GDP which is the present level.

Therefore it is evident that one of our primary tasks should be to improve the Capital : Output ratio. Some of the major contributing factors to this inefficient usage of capital are:

(i) The increase in proportion of investments made by extremely inefficient public sector selectively in capital intensive sectors. This was the result of the policies of "Reservations" and "Dominance of Public Sector".

(ii) The failure to invest in modern technology because of either the tie-up with backward sources of know-how, or the over-emphasis on indigenous sources which have been unable to update their technology due to severe import restrictions.

(iii) The obsession with self-reliance which lured us into building inefficient and often under-utilised, capital intensive plants to manufacture machinery and equipment which were, in many cases, better imported. Our capital should have been spent more on projects that gave quicker return.

To reverse this trend and return to a more efficient use of capital it will be therefore necessary to open up more industrial sectors to the private sector. It will also be necessary to open up the flow of technology into the country and encourage further internationalisation of the sources of technology for Indian industry. We will also have to be more selective in capital intensive projects and not keep self sufficiency as the sole consideration.

If we could improve the capital : output ratio from 3.3 to 2.5, the effect would be to raise growth by nearly 3% per annum. It is purely within our control.

We do not need any foreign help or understanding with other countries. On the other hand, if we show ourselves to be an efficient user of capital, the image of India as a source of supply can also change dramatically. Today, we are in some ways suffering from what in the West was called the 'British Disease', i.e. inefficient and monopolistic public sector dominated by outmoded craft union attitudes which saps the will to improve efficiencies or to compete in the world. Even British companies preferred to buy from abroad as there was no investment in modern technology and the delivery schedules were always uncertain due to labour troubles. They had to be bailed out by IMF in 1976. Since then attitudes have changed, gradually at first, and dramatically in the last 3 years. After the change of Government in 1979, there has been a sea change in attitudes and philosophy. Public Sector is no longer the holy cow that it used to be. It is being forced to improve productivity and competitiveness. Several of them are scheduled to be privatised when they become sufficiently profitable. Unfortunately for them, the squeezing out of surplus labour had to be done during a period of negative or nil growth in the economies of the world. So they have high unemployment; but then so have all the other major Western economies now. Once economic growth resumes, they will have a more efficient base to grow from, with a less dominant public sector and less militant craft union attitudes.

This transition taking place in UK has a great lesson for India. After all, we got most of our ideas of "Socialism" and "Public Sector" from them. It will be very worthwhile for us to keep track of what has happened to them and how they are changing course. Fortunately for us, we are a growing economy. Therefore we do not have some of their limitations and we do not have to make a U-turn which is always a bit convulsive. For instance, we do not have to de-nationalise as they are doing. We have only to throw open more sectors to private industry so that the public sector will have some competitive urge to improve and need not remain so dominant. We also will not face the problem of de-employing millions, because almost all enterprises in India can absorb their potential surplus through growth, as ours is a growing economy which can even grow much faster. So we are in a much better position to adjust our course than many other countries. We are hopefully seeing some signs of change.

## Enhancing the availability of Investment Capital

One way of increasing the capital available will be to increase the rate of savings for investment from the current level of about 20% to above 30% of GDP. It has been estimated by the Government in its submissions to the IMF last year that during the period ending 1984/1985, the savings rate will increase to 24.5% of GDP.

About 73% of these savings are from the private sector, mainly through taxes and voluntary means. It is doubtful whether this source of savings can be stretched any further, especially as an increasing proportion of taxes are levied as indirect taxes paid by all sectors, including the poor.

The other source of savings the Government is hoping to become available is surplus from public sector investments. This is expected to contribute over one fifth of total investments. However if the public sector surplus is merely a result of increased prices of coal, steel, power, etc. and not a result of genuine improvements in efficiency and productivity, it will be purely notional as it will be only an inter-sectoral transfer. Therefore, this particular expectation, whilst important and necessary, may be somewhat optimistic in the restricted time-span. Furthermore, public sector, with its very direct linkages with bureaucracy and politicians, will find it very hard to effect any real improvements in productivity. Even in totalitarian states, this has proved to be difficult; in a democracy it is even less likely. So this source of increased availability of capital has limited scope.

The third source of investment which the Government has taken into account in its planning is the flow of investment capital from external sources to the extent of 6% of total investment.

If we wish to increase the investment levels from the present 20-21% level to the 25-30% level, the additional 5-10% could well come from external sources. In other words, the Government should (and according to me, it can) evolve a strategy to almost double its present expectation of capital flows from external sources, i.e. raise it from 6% to 12% or more.

We can do so by making use of the savings accumulating in the more affluent societies of the world. Every country, including the so-called centrally planned economies, are doing so. They do it not only to attract capital but also to obtain the best technology as illustrated by the USSR, taking from a consortium of Western European countries (Germany, France, UK, etc.) finance, technology and equipment for gas gathering and piping, from Russia to Western Europe. Furthermore, most of the dealings by Russia are with private sector Western companies. If Russia needs it and takes it, how much more should we be needing and using it!

In the remaining part of this talk, I shall examine some of the realistic options available to India for increasing the level of investment funds from external sources.

## Choices open to India

**The channels available to India for investment funds abroad are: (i) Official flows; (ii) Private financial institutions; and (iii) Direct investment. We shall examine each of these.**

*Official Flows*: Official flows are crucial to the development process as they are offered through bilateral and multilateral arrangements at concessional rates and with longer maturity periods which are necessary for infrastructural investments. However, it will be unrealistic for India to expect any significant increase in the level of such funds be it from bilateral sources or from the World Bank affiliates. This is because first of all, the donor countries are themselves under tremendous pressure arising from the need to restructure their own economies. Secondly, the increased claims on the international official finance will shift it away from India. For example instead of 40% of IDA funds, we will hereafter get perhaps only one-third.

Thirdly, during the critical world economic situation of the early 1980s, India, like many other countries, may find that the official sources need to be tapped not for investments in projects, but for bridging loans to be used during periods of adjustment like the current IMF loan.

Fourthly, India's foreign public debt as a percentage of GDP is already at a level of about 12% as shown in Chart IV.

It is only Mexico, Brazil and the Philippines who have significantly exceeded this level. It may not be prudent to go much further, especially when one looks at the cost of servicing the public debts. India has been very fortunate in having a very low service charge (6.2% of debts) as compared to that paid by other countries (ranging from 10 to over 12%) because of the high proportion of concessional IDA loans made available to India so far. But if we increase the proportion of our borrowings from multilateral sources in the future, the debt servicing charges as a percentage of loans are bound to go up to almost double the present level as in the case of other countries shown in the table. The World Bank itself is reducing our access to IDA loans and also raising the charges on its normal facilities.

Fifthly, it will not be in our long-term interest to increase the proportion of multilateral funds because a built-in feature of this source is that by its very nature, it tends to flow preferentially into 'official' channels in the receiving country viz. the Governmental bureaucracy and public sector. Both of them are the less efficient arms of an economy as almost all countries in the world including the so-called centrally planned economies are discovering. It is even more true of India where the public sector and Government are already in such commanding positions that any further proportionate addition to their weightage will smother the economy under sheer inefficiency.

Lastly, there is a global psychological factor to be taken into account with regard to official flows. Whether they are called 'grants' or 'aid' or 'IDA loans' etc., it is ultimately based on charity of the developed countries—some out of enlightened self-interest, some out of a conscience. But in their eyes, any country which depends so much on such charity invokes an image of pity and backwardness. I think we deserve better than that. Our officials, who negotiate these loans with their counterparts in other countries, may or may not sense this negative impression which is politely concealed from them. But it is there and it colours the attitudes in the donor countries when it comes to trade and politics. If China is more respected than India, one of the reasons among others, is that China is not so dependent on this factor of charity. I think India can improve its image considerably by not increasing our dependence on official channels. And image is a very important though intangible asset for our country.

*Private Financial Institutions:* Private financial institutions like banks and bond markets have been a major source of funds during the last few years. The external debt of capital importing developing countries doubled between 1977 and 1981 to a figure of $475 billion. During the same period the share of commercial bank debt in this total amount increased from 40% to 60%. In other words, loans from commercial banks to developing countries virtually trebled from about $95 billion to about $285 billion during the last 5 years. This was facilitated by the easy availability of funds with the banks who were eager to lend during that time. Now, of course, some of their problems are coming home to roost.

Commercial bank loans have a key role to play as they are available to the private sector which is usually denied access to any of the official flows. However, we should not be oblivious to some of the limitations of commercial loans. First of all, a significant part of such loans is short term and can be used only for financing trade. This is because capital surplus countries, e.g., OPEC deposit their funds with the banks only for short terms as they wish to protect their own options. Even the longer term bank finance is for periods of up to 10 years only. Secondly, the interest cost is usually determined by adding a fixed margin to a fluctuating base interest rate like LIBOR. Therefore, there is considerable uncertainty about future liabilities as recent events have so clearly demonstrated. Thirdly, bond markets and bank credits are subject to intervention by Governments in developed countries. And lastly, there is a very significant factor of exchange risks to which the borrower is exposed which adds to the uncertainties. While India can still afford to borrow considerably more from the international commercial banks the above limitations are bound to restrict the usage of these loans in long-term development projects.

In any case, the climate for borrowing internationally is far from encouraging. The world's banking system is facing the worst crisis in its history. With countries in Latin America owing more than $200 billion (including Mexico 80, Brazil 70, Argentina 40), the nightmare that haunts the bankers is that one or more of these countries may go into prolonged rescheduling if not into default. Then there are the problems of the East European countries like Poland and Rumania who are in the same boat. Nine American banks have lent nearly twice their combined capital to just six developing countries. The most prestigious credit rating agency in the USA has downgraded all but one of the nine banks from their triple 'A' rating. So the banks have gone in too deep for their own comfort and will not be keen to expose themselves much more.

From the developing countries' point of view, the quantum of short-term debt which is so unsuitable for the needs of development has grown steadily since 1977—it used to be only 13% of borrowings; now it is 25%. To service these debts and to keep up repayments, developing countries have to devote 50% of their export earnings. It exposes the developing countries to enormous risks which are perhaps best illustrated by the dramatic experience of Mexico.

After a miniature economic crisis in 1976, Mexico decided to fuel its growth on the basis of borrowing to give a head to its under-developed petroleum industry in the expectation that petroleum revenues would meet the repayment obligations. For a while, it all went with a swing. Mexico was the blue-eyed baby of the inter-national bankers. It amended its foreign direct investment laws so that direct investments were discouraged and borrowings were welcome. An economic growth rate of 8% per annum was to be achieved. During this boom period—1976-81—the borrowings mounted to $83 billion of which $63 billion was in the public sector and $20 billion in the private sector. Mexico rose to be the fourth largest oil producer, more than half of which was exported. Large borrowings of over $25 billion were made for the public sector Pemex Oil Company. The private sector was not left behind and the Alfa group borrowed $2 billion for its diversification from steel and cement into bicycles and tourism. Well, the bubble has burst and the Government of Mexico has to negotiate over $10 billion of accommodation to balance its books for 1982. Suddenly from the blue-eyed baby, Mexico has turned into the awkward adolescent. What went wrong in Mexico holds lessons for India in evolving a policy on borrowings.

First of all, Mexico's economic performance had become highly sensitive and vulnerable to the demand for and the price of petroleum. It is very similar to a one-product company. India's continuing dependence on agriculture is somewhat similar.

Secondly, Mexico built up an over-ambitious growth rate based on heavy investments in the public sector, largely centred on oil and related industries. The risk was therefore to be borne entirely by the Mexican tax payer who is now facing the immense liabilities for bureaucratic ambitions in the public sector. This phenomenon is not too unfamiliar for us in India, although mercifully, it is on a smaller scale.

Thirdly, in raising resources for its hurried development, Mexico chose to substitute increase in domestic savings by going in for massive injections of funds from abroad. While it was politically expedient in the very short term, it was extremely risky as events have proved. In India, fortunately, we have already a very high measure of domestic savings and we have erred on the opposite side of not making enough use of funds from abroad.

Fourthly, Mexico chose to borrow in short term bank loans for 4 to 6 year periods rather than encourage direct investment from abroad. This was caused by over-confidence and a measure of xenophobia, especially against American investors.

In the event, it would have been far better to have got direct foreign investment than borrowings. This has a lesson also for India.

Lastly, Mexico forced the pace well beyond the inherent strengths of the economy. Fortunately for us, no one can accuse India of any such over-ambitious forcing of the pace. However, paradoxically, we are in a better position to do so than any other developing country in the world because we have an oversupply of entrepreneurs, managers and specialists of international calibre.

Thus, whilst borrowings from private sources is a very useful and important source, the scope is mainly in financing trade and not for long-term development projects. The risks have to be fully evaluated, and borrowings have to be limited in relation to own sources. In this sense, financing of a national economy is similar to that of a company. If borrowing exceeds prudent proportions of equity capital, it is a highly vulnerable venture. High gearing in a nation is even more dangerous than in a company because ultimately the price has to be paid in terms of widespread instability.

Now let us look at the third option.

*Direct Investment*: The other option open to India is to attract direct investment from abroad, not as loans, but as equity. Compared to loans, this type of investment has the following advantages from the point of view of the host countries:

(i) Their effect tends to be counter-cyclically advantageous to the host country. When our economy is slack, the returns on such investment and hence its cost, tend to be low also.

Conversely, in the case of loans, when economies perform badly, the interest rates rise and therefore the burden tends to increase. One can appreciate it much more if one took the example of Mexico. If Mexico had managed to attract even one-third of its inflow as foreign equity capital instead of direct borrowings, it would not be facing the enormous crisis it does today.

(ii) From the point of view of the host country, there is no exchange risk involved in equity investments unlike in the case of most loans. There is a very significant risk in loans, especially for borrowings in developing countries whose currencies tend to depreciate against the stronger currencies of the world in which the borrowing takes place. Here again, the Mexican example is telling! Over the life of a loan which may be 5-10 years, the risk is considerable. All remittances of interest and capital have to be made in the foreign currency. In contrast, if an investment is made as equity capital, it is at once converted into the local currency and all returns on it are earned in local currency against which remittances can be made. This is a much safer proposition.

(iii) Whereas loans carry a contractual obligation for interest and repayments, equity investment does not create any such obligation. In fact, profits arise only after a few years, and some of it is always retained in the business for expansion. For instance, on an international loan today, an Indian borrower will have to pay 15% interest with repayment spread over 10 years. If the same capital can be persuaded to come in as equity, there will be no remittance for the first 3 years while the project is being built; then it may be another 2 years for any profit after tax to be made. Even when it is made, the dividend will be only 50 or 60% of the profit after tax. This dividend is then subject to a tax of 30% when it is remitted so the outflow tends to be considerably less.

(iv) The injection of equity funds from abroad broadens the base for further infusion of investment capital in two ways. Firstly, a larger equity base enables larger borrowing. Secondly, foreign private capital always tends to act as a catalyst that attracts more of the domestic equity capital. This is not a magic function, but is due to the generally well-founded confidence of the indigenous investor in the management and technological skills of international companies. Therefore, in some ways, foreign capital is a bait to promote domestic equity investment.

(v) Equity investment usually brings with it more than money. In my own experience as the Chairman of a subsidiary in India, and now as an investor from the Centre into other countries, the two outstanding contributions brought in by foreign capital are in the areas of management skills and technology. It is worth noting that even today, some of the best professional management in India comes from those companies who had some form of foreign investment. Even among Indian companies which have had foreign collaborations, the international influence on management attitudes and practices is discernible. This is because the management development procedures introduced and operated by the international companies facilitate a process of evaluation and planned development of individual careers based on merit and potential. They tend to invest more resources of a higher calibre for this purpose. As a result the host country builds up a reservoir of management.

The other benefit is that of technology. International companies which are subject to much higher levels of competition than those operating in relatively protected markets like India, have to invest in developing new technologies to improve their products. This is often a series of changes that take place over a period of time with an occasional revolutionary change. International investors bring in this at very little cost. It is interesting to note that it is not only countries like India that need to get this transfusion. One of the important purposes of Mrs. Thatcher's recent visit to Japan was to ask for more Japanese investment in UK. She personally visited and pleaded with Nissan to invest in a car factory in UK, not because she needs £500 million worth of capital. In fact they don't need it because UK is an exporter of capital.

What UK needs is the infusion of Japanese car manufacturing technology into Britain so that their automobile industry becomes competitive with the Japanese and Continental manufacturers. Without that, very soon UK may be left with no automobile industry. Perhaps this is the best illustration of how even a developed country woos foreign capital to obtain the benefit of improved technology. One of the weaknesses of Indian industry has been its relative isolation from international technology. The world has left us behind in many crucial areas and one of the most effective ways of catching up is to promote partnerships with those who have the technology.

The price is only our false pride but the rewards are enduring.

The other very important point about both management development and technology is the leavening influence which these international investments have on the rest of industry. Their managers and the culture of professionalism and constant drive for modernisation of technology exert an influence on the rest of industry around them as I have seen in India and is evident in other parts of the world too.

When foreign direct investment flows into a country, there is a general improvement in the confidence of the international investing community in that country. This has several benefits provided it is not allowed to run wild as in the case of Mexico. First of all, if some significant investors stake larger amounts in a country, others in the same league begin to sit up and notice. For instance, whether we like it or not the attitude of a Shell or Unilever or an ICI about India has a much greater influence on investors in London or New York or Tokyo than any amount of pronouncements made by people here. Therefore, for instance, if Shell were to invest in offshore oil in India, other international oil companies, and then many others, will tend to take a more favourable view of India, including lenders who will offer better terms. It will certainly influence the Middle Eastern investors and I am sure even Indians living abroad who now invest their earnings abroad, will feel more confident to invest in India rather than in other places. Thus the increase in direct foreign investment will bring about a qualitative change in attitudes towards India which is much more significant than we realise in India.

These then are some of the distinct advantages of direct foreign investment. But it has to be recognised that so far, most people connected with economic development of the Third World including the Brandt Commission, have tended to treat this as a rather minor source to be approached with great caution, if not suspicion. However, things are now beginning to change and the World under its new ex-Banker President, is recommending a change. The World Bank report on India for 1981 states clearly that we will have to make much greater use of foreign investment if we are to achieve our investment targets and the following quotations are relevant:

"Direct private foreign investment so far contributed relatively little of India's foreign savings requirements and although scope is limited, technical collaborations and direct investment can play a greater role in fostering the technological modernisation needed for adjustment without significantly altering the framework which regulates the role of foreign business interests in India."

"Clearly, both commercial borrowings and private foreign investment can play an important role in financing India's foreign savings during the 1980s. In the case of commercial borrowing, India is well on the way towards a judicious use of these resources. It is less clear however, why foreign investment has thus far contributed so little, given the generally favourable domestic environment, and apparent gain to both investor and recipient."

"The role of external resources in the Indian economy is certainly more critical now than at any point during the past decade, but qualitative effects of a greater role for the external sector are even more relevant to the improved performance on the Indian economy."

Thus, it is clear from the foregoing analysis and the latest recommendations of the World Bank that India should seek greater inflow of foreign direct investment. Let us now examine what are the problems and prospects involved in any such attempt.

## Inhibitions Against Direct Investment & Some Solutions

If the advantages of direct foreign investment are so significant as I have outlined above, one wonders why more equity investments have not been flowing into a country like India. The total foreign private investment in India is only about Rs. 2,500 crores out of a total of Rs. 60,000 crores in private sector industry, i.e. only about 4%. If we include public sector industrial investment, the percentage will be under 2%. Furthermore, much of the existing investment is historical. There is very little fresh flow of investment capital into India. I would therefore now analyse the main causes of this and identify some possible solutions to facilitate a better flow of funds.

*Domestic Inhibition*: First of all, there is the domestic political view that any encouragement of direct investment will lead to a takeover of this country by foreign companies and multinationals. This is a myth that needs to be exposed.

We are living in a world that is wooing investors from abroad. The most recent and glaring example is the one I have already referred to, viz. that of Mrs. Thatcher going to Japan soliciting investment.

Here is the Prime Minister of a highly developed country whose Government incidentally owns a large and losing automobile company, cajoling their most fierce competitor to invest in her own country. This is because everyone realises that it does not matter very much from where an investment comes. What matters is the conditions attached to it and the results from it. If Britain, which now has a positive balance of payments, and actually exports capital, finds it desirable and necessary to invite foreign direct investment to modernise an industry which was virtually born in that country, how much more should we be doing it! In fact, in many ways, we are in a much better position to do so because any investment that comes into India will be adding to our industrial assets and not displacing any existing ones as it will do in Britain. Furthermore, India already has a FERA which can be suitably used to regulate the sectors into which such investments can be directed. Unlike many other developing countries, India has such a vast number of entrepreneurs and professionals that we need have no fear of any economic domination if we stepped up direct investments. In that sense, we are already a developed country in terms of human skills.

We should always bear in mind that once a foreign investment is made in India, that investor is very much at risk and at the mercy of domestic policies and events. In a vast country like ours, he will soon find that it is better to attune the objectives of his business to those of the country if he wishes to remain here. I can bear personal testimony to this as I am associated with the remaining single largest foreign investor in India. We have to conform to the policies and aspirations of our country whatever may be the pattern of ownership. The only courses open to those who do not wish to conform is either not to come or to get out. You can see this in the case of all the foreign investors who made their responses to FERA. By and large, over the last 8 years, both the Government and the investors have sought and found accommodation within the framework of the law. What is now needed is an effective use of the policy that has been evolved through this process of accommodation.

Of course there will always be some leftist parties who will continue their slogans. But even they, like in West Bengal, would welcome investments in their own state, irrespective of where it came from. And their model countries Russia, China and all the East European countries woo multinationals more than India does. So their criticism should not be a deterrent in shedding our inhibitions.

The most effective way of removing the domestic inhibition is for the Prime Minister to make a policy statement, as Panditji did in April 1949, when he said "Government would so frame their policy as to enable further foreign capital to be invested in India on terms and conditions that are mutually advantageous". Such a policy statement will give the necessary mandate to other Ministers and most importantly, to the Civil Servants who have to administer the rules and regulations. Once they get the green light and reflect it in their attitudes and actions, the message will be clear, both in India and abroad and inhibitions will begin to disappear. According to me, this is the first stumbling block to be removed if India is to attract any significant level of direct investment.

*Availability of Funds*: Another limitation is the availability of funds in the international markets for direct investment. The profitability of companies in many Western countries is such that they do not have large sums of money for investment, especially in the developing world. Many sectors of industry like automobile, steel, ship-building, engineering, petrochemicals, etc. are facing particularly hard times and investment by companies in these sectors will be very limited for some years to come.

However, for India, there is one unique possibility that has yet to be fully explored. Since the Yom Kippur War of 1973, the OPEC countries have accumulated a surplus of $389 billion. This, of course, is the mirror image of the deficit faced by the rest of the world. However, so far, the Arab countries have placed a major portion of it in banks in different countries. They have not found it possible to invest it all in assets that will bring the rewards of growth. The scope for such investment in their own countries is limited because their population is only a few million and the market is too small. Their ability to invest such huge sums in enterprises outside their own territory is limited by their lack of indigenous resources in terms of technology and management to match the scale of investment. It is also possible that they will not feel very secure to undertake the risk of investing large sums in powerful countries which are much bigger than them and could apply sanctions against them as the US did with Iranian assets.

But all this creates an opportunity for a country like India, which has very friendly relations with the Arab nations. The opportunity for investment in India is vast and it is a politically stable country. If India could join forces with private enterprise in the West, it should be a secure and attractive investment area for the Arabs. Western private enterprise can provide the technology and some of the management, which could be backed by finance from Arab countries. If the Indian Government or private enterprise by itself tries to woo Arab investors, we won't inspire adequate confidence. However, if our plans are formulated in conjunction with well-established Western private enterprise, it will create a very much more attractive package.

This can perhaps be best illustrated by an example which holds real potential for India and is based on my personal knowledge. India imports now about 1 million tonnes of edible oil every year at a cost of about half a billion dollars, even at depressed prices. This is likely to increase in future if we don't do anything. Apart from improving groundnut crop and introducing soyabean and sunflower, one of the steps we can take is to go in for large scale oil palm plantation. We could easily set a target of producing half a million tonnes of palm oil by 1990. It will still be only 15% of what Malaysia produces now. The half a million tonnes will need about 100,000 hectares at current yields per hectare, which are likely to increase in the future. The land required is therefore 400 square miles which can be easily found between North Eastern India and the Andamans. It will require an investment of about £200 million and the management skills of those who have successful experience. If the Indian Government made a policy that foreign investment will be permitted in this area, it should be possible to use the good offices of the International Finance Corporation in Washington and the Commonwealth Development Corporation to bring together enough investors from abroad—Arab or Western—and domestic investors and institutions to finance and to manage such an enterprise. I can say with great confidence that it can be done as it is being done in Colombia and even in Ghana. It should be easier in India, and it can be done within the framework of FERA. But the initiative has to be taken with the support of the Government of India.

It is time for our Government to formulate such specific schemes for triangular investment in priority areas and thereby attract potential investors rather than live with our inhibitions and wait for the Prince Charming to come on his golden chariot. He may never come or it could be the wrong Prince chosen in desperation!

Such joint investments are attractive to all parties concerned and have no specific disadvantage for any one of them. From the Arab's point of view, it is advantageous to divert some of his funds to a growth economy like India under the umbrella of Western technology and management practices. From the point of view of the Western companies, they are able to gain access to a large and growing economy. And for us in India, it directs investment efficiently into areas of greatest priority to our country without having to finance it entirely from our savings. If such packages can be evolved and promoted, availability of funds will cease to be a limitation.

*The Image of India*: Another limitation which applies to direct investment is the image of India. As I described earlier, India seems to be changing from a period of 'Isolation' to a period of 'Innovation' in attracting investments. But this change of attitudes has to be sold to prospective investors. It is not enough if statements are made in Delhi or to IMF and other agencies. In selling anything, especially a change for the better, there are two crucial steps. The first is to make sure that there is a genuine improvement and the second is to convey this message effectively to the audience. It is very much like selling an improved version of an existing product, say a soap. The first step for the maker is to make absolutely sure that the new product is a significant improvement on the older one—not only as the manufacturer evaluates it but also as the consumer judges it. On this basis, are we sure that the recent change in attitudes to investments from within or outside the country are reflected in the administration and procedures in the various relevant Ministries in Delhi and the states? It will be very worthwhile for the Government to constitute a "consumer panel" of industrialists in India and abroad to test its image, the changes that have been or are going to be made and the effect as perceived by the "consumer" who, in this case, is the industrial investor. Such consumer research has to be conducted by unbiased professionals and not by spot checks by those in the Government who tend to be given misleadingly exaggerated favourable versions by those who are too eager to please.

If we can establish objectively that there is an improvement as perceived by the 'consumer' panel, then it is worth communicating the message to the general public. Without a genuine improvement, the product will be rejected and all the communication effort will be frustrated. Assuming that we are able to effect significant and genuine changes, especially in the administration of policies that govern investment in India, the best medium to communicate this message to the international community is the Indian businessman. Using Ministers or Civil Servants to do this will not be as effective as people will tend to be sceptical about their claims. But if well-known Indian businessmen convey the message, it will have greater credibility.

So, if India has to attract investment from outside, it will be very necessary, first to convince Indian businessmen that there is a genuine improvement, and then to persuade them and use them to communicate this change to their international counterparts through actual investment projects. This will take a lot of systematic planning, humble re-appraisal of policies and genuine appreciation of the capabilities of the Indian private sector. For the outside world, there is no doubt about the skills and abilities of the Indian businessman or manager; but almost all the inhibitions are fortunately centred on Government administration. I say fortunately, because it is something that can be changed for the better, dramatically by the top leadership in Government.

*Avenues for Investment*: If we are attracting investment from abroad, we should also be clear and consistent about the areas on which we should attract and permit such investment. Judging by the needs of our country and the scale of investments required, the priority sectors should include the following:

i) Agricultural inputs—nutrients, agricultural chemicals
ii) Electricity generation
iii) Communications
iv) Transportation
v) Modernisation of traditional export oriented industries like jute, textile, engineering.

This list is only illustrative. It does not conform to some existing lists of permitted industries for private sector—indigenous or mixed. But we should be bold and wise enough to revise our priorities according to the realities of the present world. For instance, why should electricity generation or communications be under the monopoly of State Governments? A change over to modern private enterprise will improve the services and reduce the burden on the exchequer. There are areas crying out for investment and if we do not modernise them, we will be increasingly left behind. Therefore, it is more important to throw open these sectors to triangular investments rather than attract such investments in hotels or synthetic fibres.

It is absolutely necessary to revise the list of priorities as a part of the 'Image' exercise and then have a consistent policy at least for 10 years.

## Conclusion

To sum up, the pace of economic development in India can be substantially improved by opening the doors more widely to private enterprise and by making greater use of external resources. In considering external sources of finance, we can be more innovative and widen our choice from official aid and commercial loans to direct foreign investment, which has several advantages when used selectively. It will enable us not only to tap an important segment of capital, but also provide access to technological and managerial skills which are as important as finance. As a very rough estimate, it should be possible for us to attract about $10 billion of direct foreign investment over the next 5 years. It will enhance our stock of capital on a permanent basis and accelerate our pace of development.

This will of course, require an innovative approach, both to overcome our own inhibitions and to improve the image of India abroad. That is the essence of the strategy that I have outlined tonight. It will also require a restoration and strengthening of faith in the Indian private sector. Fortunately, for those of us who believe in the Indian private sector, such restoration of faith seems almost inevitable because the whole world, with some temporary exceptions, is going through a phase of re-structuring away from public sector and welfare oriented economies to private enterprise systems that will ensure more efficient use of available resources. There is a greater realisation in almost all countries that the private sector has a better chance to achieve this than the state enterprises. I am sure Mr. A. D. Shroff, if he were with us tonight, would have been delighted to see this worldwide trend, which will inevitably influence attitudes and policies in our own country.

The views expressed in this booklet are not necessarily the views of the Forum of Free Enterprise.

CHART I

## World Production: Annual Rate of Growth in Gross Domestic Product (Percentage)

| | 1971-80 | 1980 | 1981 (a) | 1982 (b) | 1983 (b) |
|---|---|---|---|---|---|
| World | 4.1 | 2.1 | 1.2 | 1.9 | 3.4—3.6 |
| Developed Market Economies | 3.4 | 1.5 | 1.2 | 1.3 | 3.3 |
| Centrally Planned Economies (c) | 5.4 | 3.5 | 1.9 | 3.2 | — |
| Developing Countries | 5.6 | 2.9 | 0.6 | 3 | 4—5 |
| Capital Surplus Countries | 4.8 | —7.4 | —10.1 | — | — |
| Deficit Countries | | | | | |
| Other Energy Exporters | 6.0 | 6.7 | 5.4 | 4 | 5—6 |
| Energy Importers | 5.6 | 4.1 | 1.4 | 3 | 4—5 |

*Source:* Department of International Economic and Social Affairs of the United Nations Secretariat, based on official national and international sources.

(a) Preliminary estimates

(b) Forecast: Project LINK results for developed market economies; estimates based on annual and medium-term plan figures for centrally planned economies; Secretariat estimates based on forecasts for individual developing countries.

(c) Net material product.

# Medium-term growth trends in the world economy (Average annual rate of growth over a five-year period)

| Period | Gross domestic product | | | | International trade | |
|---|---|---|---|---|---|---|
| | World economy (a) | Developed market economies | Centrally planned economies (b) | Developing countries | World exports (c) | Non-oil exports (d) |
| 1960—1964 | 5.7 | 5.4 | 6.2 | 6.7 | 6.6 | 6.6 |
| 1962—1966 | 5.7 | 5.6 | 6.4 | 5.3 | 7.0 | 6.6 |
| 1964—1968 | 5.8 | 5.5 | 7.7 | 5.5 | 8.3 | 8.0 |
| 1966—1970 | 5.6 | 5.2 | 7.4 | 6.2 | 9.0 | 8.8 |
| 1968—1972 | 5.6 | 5.1 | 6.4 | 7.2 | 9.5 | 9.8 |
| 1970—1974 | 4.9 | 4.2 | 6.9 | 6.8 | 8.7 | 9.6 |
| 1972—1976 | 4.1 | 3.4 | 6.3 | 6.0 | 6.7 | 7.6 |
| 1974—1978 | 3.4 | 2.6 | 5.5 | 4.9 | 4.3 | 5.5 |
| 1976—1980 | 3.9 | 3.6 | 4.1 | 4.8 | 5.4 | 6.3 |
| 1977—1981 (e) | 3.0 | 2.8 | 3.3 | 3.8 | 3.2 | 4.4 |
| 1978—1982 (f) | 2.6 | 2.3 | 2.9 | 3.2 | 2.9 | 4.0 |

*Source*: Department of International Economic and Social Affairs of the United Nations Secretariat. Output growth rates are based on data collected by the Secretariat from official sources; growth rates of international trade are derived from the world tables in International Monetary Fund, *International Financial Statistics*.

(a) Excluding Albania, China, the Democratic People's Republic of Korea, Mongolia and Viet Nam.

(b) Net material product of Eastern Europe and the USSR.

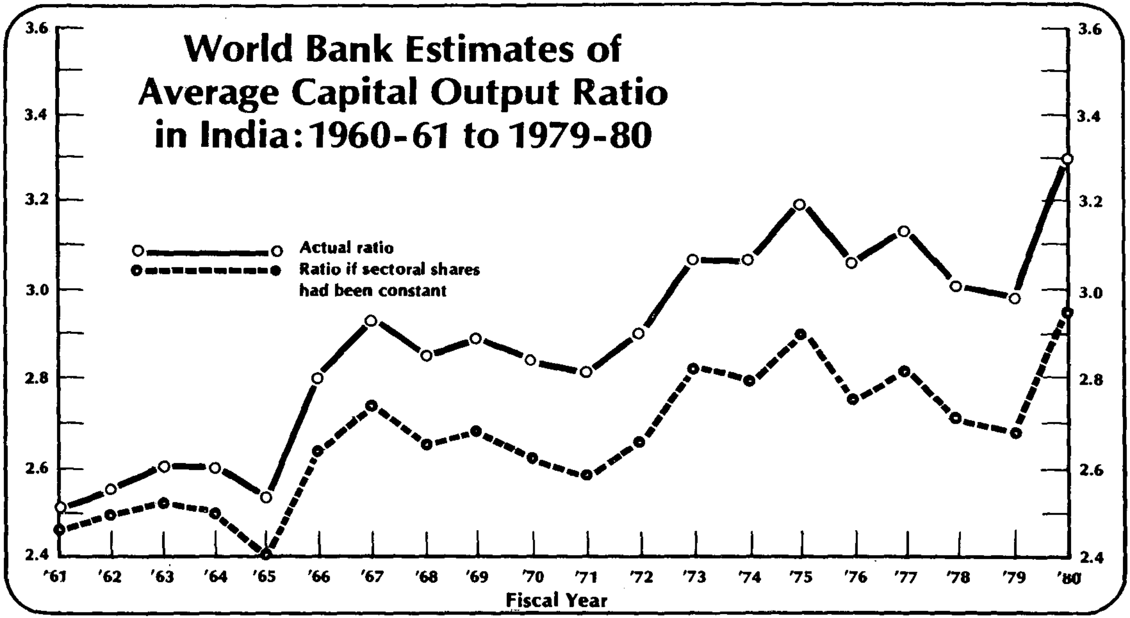
(c) Volume of exports (world exports divided by unit value of (exports).

(d) Calculated by subtracting from the total volume of exports the export volume of oil-exporting developing countries (for definitions, see International Monetary Fund, *International Financial Statistics*).

(e) Preliminary estimates for 1981.

(f) Growth rates for 1981 are preliminary estimates and for 1982 forecasts.

CHART III



World Bank Estimates of
Average Capital Output Ratio
in India: 1960-61 to 1979-80
Actual ratio
Ratio if sectoral shares
had been constant
3.6
3.4
3.2
3.0
2.8
2.6
2.4
'61
'62
'63
'64
'65
'66
'67
'68
'69
'70
'71
'72
'73
'74
'75
'76
'77
'78
'79
'80
Fiscal Year

# Foreign Public Debt and its Servicing 1980

| | Foreign Public Debt | | Foreign Public Debt Service | | |
|---|---|---|---|---|---|
| | $ million | As % GDP | As % GDP | As % Exports | As % Foreign Public Debt |
| India | 17546 | 11.9 | 0.7 | 9.2 | 6.2 |
| Colombia | 4294 | 12.8 | 1.7 | 10.3 | 13.2 |
| Mexico | 33490 | 18.0 | 4.2 | 32.0 | 23.6 |
| Brazil | 38260 | 15.4 | 3.2 | 34.7 | 21.1 |
| Thailand | 3684 | 11.0 | 1.2 | 4.7 | 11.0 |
| Malaysia | 3103 | 13.0 | 1.4 | 2.2 | 10.5 |
| Philippines | 6402 | 18.1 | 1.6 | 7.1 | 8.8 |

*Source*: Derived from World Bank 'World Debt Tables'

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