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EXPLORATORY MEETING

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The enclosed paper entitled **"FDI and the Indian Experience"** by Rajan R Gandhi of CUTS, India, is submitted in response to a request by Dr Mehmet Ogutcu, Head, Non-members Liaison Group and Global Forum on International Investment of OECD.

The request was to specifically present a paper on the Indian FDI situation, outlook and policy challenges as seen from an NGO perspective.

The paper will form the basis of the presentation by Rajan Gandhi at the Panel Discussion in Session 3 of the Exploratory Meeting.

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FDI AND THE INDIAN EXPERIENCE

Executive Summary

The paper compares the actual inflows as well as the Performance and Potential Indices of FDI into India and select countries of Emerging Asia.

Although there are some encouraging signs for India, it is clear that the FDI inflows into India are far from adequate and that there exists a large unfulfilled potential.

Some apprehensions about and resistance to FDI persist amongst sections of the Indian Government and the public at large. Further, deregulation has proved to be a more complex issue than envisaged and several confusing rules and regulations still remain. Finally, India suffers from negative image and perception problems. These are often quite unjustifiable but occasionally reinforced by the hesitancy and lack of will displayed by the Indian establishment.

Such factors aggregate to deter investment inflows. Nevertheless, an increasing body of decision makers is convinced of the need for FDI and the role that it can play in India's development. Civil Society Organisations can and do play a vital role by serving as advocacy groups which help to allay fears of FDI and permit more informed public opinion.

Overall, a consensus is building up that by setting its own house in order, India will automatically attract increased FDI inflows.

FDI AND THE INDIAN EXPERIENCE

The Historical Perspective:

Till 1991, inflows of private capital from overseas were negligible and averaged less than $200 mn a year in the period 1985-90. This was probably a superior situation to the negative net flows caused by factors such as nationalization of foreign oil companies in the 1960s and the closure or sell-out of foreign Companies in the 1970s. It took a very serious Balance of Payments crisis and a possible defalcation in external payments obligations to make the Indian Government decide on radical surgery, a process facilitated to some extent by the pressures to ease up on regulation and liberalise the economy.

Foreign investment which had till then been viewed with mistrust and suspicion was overnight being welcomed, indeed wooed. Initially, funds flowed in from Foreign Institutional Investors (FIIs) and Indian Companies using the Global or American Depository Receipt (GDR/ADR) route to raise funds from overseas. The Indian Corporate sector was wary of Foreign Direct Investment (FDI) and lobbied strongly with the Government to prohibit and if not, to defer the entry of foreign Companies

Commencement of Investment Inflows:

3 years after the 1991 liberalisation, FDI became a significant component of total foreign investment inflow:

Table 1: Net Foreign Investment Inflows (Million US$):

	91-92	92-93	93-94	94-95	95-96	96-97	97-98	98-99	99-00	00-01
GDRs[1]		240	1520	2082	683	1366	645	270	768	831
FIIs[2]		1	1665	1503	2009	1926	979	-390	2135	1847
Others	4	3	382	239	56	20	204	59	123	82
FDI	129	315	586	1314	2144	2821	3557	2462	2155	2339
Total	133	559	4153	5138	4892	6133	5385	2401	5181	5099

[1] Represents amounts raised by Indian Companies.
[2] Represents fresh inflow of funds by FIIs
Source: "Investment Policy – India": Biswatosh Saha for CUTS, 2002

The initial impetus was with Portfolio Investment. In the main, foreign Companies already operating in India but with a less than 50% equity stake took the opportunity to raise their shareholding levels to the maximum permitted by the Government. Additionally, a number of MNCs had entered into Joint Ventures of convenience with Indian partners, this being the only way they could have established a presence in the Indian market. Such MNCs bought out their local partners, thus contributing to FII inflows.

Local Companies were quicker off the mark and there was a spurt in inflows as the Indian Corporate sector used the GDR route to raise funds overseas. It may be recalled that interest rates in India during the early to mid-90s were significantly higher than overseas and were 18% p.a. (Prime Lending Rate) during the time that the new industrial policy was announced.

Proceeding with Caution:

The concessions and incentives offered by the Indian Government to attract foreign investment were not announced in one fell swoop, even though there were a number of models to emulate. Legislators felt it prudent to proceed with great caution since both the economic and political consequences were uncertain. Bureaucracy was reluctant to release its stranglehold on economic issues and indeed, an element of this reluctance is seen even today. Simultaneously, domestic industry lobbied for the maintenance, at least for a few more years, of its protected status and there were demands for a "level playing field".

On ideological rather than economic grounds, this position was supported by the media and civil society organisations on both extremes of the political spectrum. Indian Companies found unexpected allies in the radical Left as well as ultra-rightist groups which considered foreign investment to be yet another invasion or a violation of Indian sovereignty.

Arguments raged over issues such as the quality of foreign investment – the "potato chips versus computer chips" controversy, for instance. There was a surplus of posturing and polarisation; what was lacking was a balanced view. The Indian Planning Commission's Report issued in August 2002 tabulates the sector-wise FDI inflows over the last 9 years till 2000-01. The Engineering sector received 21.0% of FDI, Chemicals & Pharmaceuticals sectors received 14.3%, Electronics & Electricals received 12.5%.

As against these, the "potato-chip" sector such as Food & Dairy received 5.8% and Domestic Appliances, a scant 1.5%. Regrettably, such data is rarely projected by headline-writers and those with vested interests.

The ‘Fits and Starts’ Approach:

The original policy declaration in 1991 which laid the foundation for foreign investment in India clearly laid down the Government’s expectations, which were:

- Technology transfer
- Marketing expertise
- Introduction of modern management techniques
- Export promotion

‘In order to invite investment in ***high priority industries***, requiring ***large investments*** and ***advanced technology*** it has been decided to provide approval for direct investment ***up to 51%*** in such industries”

(Statement on Industrial Policy, 1991, pg 4). [Emphasis added].

With the passage of time, it was becoming clear that the objectives were not being achieved. Relaxations, further concessions and additional inducements were offered mostly as reactive rather than proactive measures. Most important amongst these are:

1992: *Foreign firms obtained automatic rights over international brand names.

1993: *Requirement for industrial licensing in specified industries (white goods, entertainment electronics) abolished

*FIIs allowed to invest in new Mutual Fund schemes

1994: *Banks allowed to set their own rates for lending

*Companies allowed to issue preferential equity to FIIs

1996: *Overseas pension funds, charities, foundations qualify as FIIs

*FIIs allowed to invest in un-listed firms

*FIIs allowed to invest 100% of funds (previous 30%) in debt Instruments

1998: *Further concessions to FIIs – now allowed to invest in Government securities,

Treasury Bills, listed and un-listed debt securities.

1999: *FIIs allowed conditional forward foreign exchange cover

*FIIs could participate in open offers in accordance with take-over codes

2000: *100% foreign equity allowed in infrastructure projects – ports, roads, highways.

2002: *Limited FDI in print media permitted

This is by no means comprehensive: several other measures, such as the repeal of the draconian Foreign Exchange Regulations Act in favour of FEMA (Foreign Exchange Management Act) served directly or indirectly as stimuli for foreign investment. The Government also periodically announced, by means of formal Notifications, relaxations in the percentage of foreign equity permissible in different industries. The term ‘relaxation’ must be stressed: in no instance has there been a tightening or reversion.

Perhaps the most important of these relaxations from the foreign investor’s viewpoint was the discontinuation in 2000 of the provision for ‘dividend balancing’ in 22 categories of industries (mainly consumer goods/consumer durables). Under this provision, dividends repatriated to the parent country had to be balanced by export earnings over a 7 year period, such exports being optionally from own production or merchant exports.

On occasion, external factors have forced relaxations in policy. In response to a U.S. complaint, the WTO ruled that the compulsion to raise the indigenous content of cars to prescribed levels was not permissible, and the Govt of India had to withdraw this clause.

Over and above the inducements offered by the Central Government were the incentives offered by provincial Governments. Land, for instance, was and still is offered at very low rates for foreign-owned factories. Waivers or concessions are routine: Ford obtained a 15 year holiday from local sales tax in Tamil Nadu. General Motors had a 30 Km stretch of road completely re-surfaced by the Govt of Gujarat.

Some of the incentives and inducements were remarkable feats of financial engineering. Enron, for example, obtained a financial guarantee from the Central Government against default by the Maharashtra State Government. Meanwhile, the State Govt agreed to purchase electricity produced by Enron at a rate determined by Enron’s capacity utilisation rather than demand and supply. Not surprisingly, such agreements collapsed.

Present Status: Performance

The present policies are such that once a foreign firm receives its permissions, (and prior sanction is not needed in most cases), it enjoys equal treatment with Indian Companies. In fact Indian industry has justifiably complained that the laws often favour foreign investors. In the telecom services sector, for example, foreign financial collaboration was made a prerequisite for all local bidders. In the power sector, more liberal terms were offered to foreign investors than to Indian ones.

Notwithstanding the wooing of foreign investment, particularly FDI, there is a feeling that FDI has been inadequate in quantitative and qualitative terms. Quantitatively, foreign investment remains insignificant relative to India’s GDP:

Table 2: Foreign Investment and GDP (Million US$)

	91-92	92-93	93-94	94-95	95-96	96-97	97-98	98-99	99-00	00-01
FDI	129	315	586	1314	2144	2821	3557	2462	2155	2339
Portfolio	4	244	3567	3824	2748	3312	1828	-61	3026	2760
Total	133	559	4153	5138	4892	6133	5385	2401	5181	5099
Total as % of GDP	0.05	0.20	1.80	1.70	1.50	1.90	1.30	0.59	1.02	1.00
FDI as % of Foreign inv.	97.0	56.4	14.1	25.6	43.8	46.0	66.1	102.5	41.6	45.9

Source: "Investment Policy – India": Biswatosh Saha for CUTS, 2002

Total foreign investment has been hovering at around 1% of GDP for the last few years and cannot be said to be making any significant impact. FDI constitutes a little less than half the total, and its impact is thus even lower.

The view is often expressed that FDI in India is not up to potential. Table 3 below provides in absolute terms the FDI inflows of India and other countries in Emerging Asia:

Table 3: FDI Inflows in Million US$

	1990-95 (Annual Avrg)	1996	1997	1998	1999	2000	2001
India	703	2525	3619	2633	2168	2319	3403
Pakistan	389	918	713	507	530	305	385
Sri Lanka	110	133	433	206	201	178	172
Mongolia	8	16	25	19	30	54	63
Chinese Taipei	1222	1864	2248	222	2926	4928	4109
Brunei	102	654	702	573	596	600	244
Indonesia	2135	6194	4677	-356	-2745	-4550	-3277
Malaysia	4655	7296	6324	2714	3895	3788	554
Myanmar	180	310	387	314	253	255	123
Philippines	1028	1520	1249	1752	578	1241	1792
Singapore	5782	8608	10746	6389	11803	5407	8609
Thailand	1990	2271	3626	5143	3561	2813	3759

Source: World Investment Report 2002, UNCTAD

FDI into India is higher than others in SAARC but low in relation to several other countries. But measurement of absolute FDI is an inadequate measure of performance since it ignores fundamentals such as the very size of the economy of the host country. The World Investment Report 2002 (UNCTAD) thus converts absolute flows into an index. The UNCTAD Inward FDI Performance Index is the ratio of a country's share in global FDI inflow to its share in GDP.

Table 4: India's Inward FDI Performance Index compared:

	1988-90	1998-2000
India	0.1	0.2
Pakistan	0.6	0.2
Sri Lanka	0.5	0.4
Mongolia	0.8	0.5
Chinese Taipei	0.9	0.3
Brunei	0	0.1
Indonesia	0.8	-0.6
Malaysia	4.4	1.2
Myanmar	1.9	0.6
Philippines	1.7	0.6
Singapore	13.8	2.2
Thailand	2.6	1.3

Source: World Investment Report 2002, UNCTAD

Two facts are immediately evident. First, that India's FDI Performance Index is very low – in fact it ranks 119th amongst the 140 countries listed in the report. On the positive side, India is the only country amongst this group whose Performance Index shows an improvement in 1998-2000 over the decade 1988-90.

The conclusion is that although the trend is favourable, FDI inflows into India are far from adequate, given India's size. However, even the Performance Indices should be interpreted with some circumspection. Under the same definitions Angola ranks 3rd amongst all nations whereas Singapore is ranked 18th.

Present Status: Potential:

The UNCTAD document under reference admits the difficulty in capturing the host of socio-economic factors affecting FDI but nevertheless, makes an attempt at ascertaining the potential for FDI for different countries based on 8 selected variables: Measured on a scale of 0 to 1, (with 1 representing maximum potential) the figures are:

Table 5: India's FDI Potential Index compared

	1988-90	1998-2000
India	0.165	0.204
Pakistan	0.141	0.159
Sri Lanka	0.135	0.187
Mongolia	0.254	0.266
Chinese Taipei	0.444	0.570
Brunei	0.315	0.424
Indonesia	0.203	0.189
Malaysia	0.252	0.368
Myanmar	0.067	0.083
Philippines	0.139	0.265
Singapore	0.470	0.641
Thailand	0.235	0.298

Source: World Investment Report 2002, UNCTAD

As a matter of interest, India's ranking in 1998-00 was 104th out of 140 countries.

The World Investment Report '02 further analyses the data from both tables and concludes that India is under-performing in terms of both performance and potential.

Existing Obstacles to FDI

The disappointment with FDI flows into India in both absolute and relative terms has led to considerable soul-searching. Whilst India claims to have one of the most transparent and liberal FDI regimes amongst developing countries, there still exist a plethora of rules, regulations and interpretations.

There are still caps on the percentage of equity holding in different industrial sectors. There are still two routes to setting up a project: an automatic route which requires no prior sanction and the FIPB (Foreign Investment Promotion Board) route. An investment exceeding US$120 million requires permission from no less than the Cabinet Committee on Foreign Investment. The route to take thus depends on the size of the investment, how much foreign equity is to be held and in which industrial sector. One-sided labour laws make it virtually impossible to downsize in the face of genuine downturns in business and act as a deterrent to green-field investment.

The Confederation of Indian Industry (CII) estimated that a typical power project would require 43 clearances from the Central Government and 57 from provincial and municipal governments. The CII found that with such red tape-ism and confusion, 55% of potential investors in 2000-2001 dropped out after obtaining the requisite FIPB approval.

Such real obstacles combine with varying interpretations and corruption to deter even the most dogged investors.

Mergers & Acquisitions:

Yet another viewpoint is that around 40% of FDI in India is in the form of mergers and acquisitions – "second-rate" FDI according to some since the eagerly anticipated benefits of FDI do not accrue to the host nation. This criticism is not truly valid. In reality, the acquisition of a domestic Company by a foreign entity is a "fast-track" method of entering an alien market since the acquirer also buys the local approvals, selling and distribution network, vendor base, skilled manpower etc of the domestic Company. It is also pertinent to note that this route releases domestic funds for reinvestment elsewhere.

Finally, it must also be recalled that many foreign Companies who were already operating in India had been forced to reduce their shareholding and merely bought back shares from resident Indian investors at prevailing market prices. This step is a precursor to expansions of manufacturing capacity, leading to increase in employment and generation of wealth.

Perceptions and Impressions:

An important factor determining FDI inflows is the perception of India and the Indian economy. The nuclear tests by India and Pakistan, the deployment of troops at the borders of the two countries, terrorist attacks in India – such factors tend to scare away foreign investors.

Impressions are often based on the uninformed and parochial views of foreign (mainly U.S) media. Such views reinforce the impression of India as a land of "snake charmers and sacred cows", scarcely worthy of investment. The collapse of inherently flawed commercial agreements (such as the one with Enron) make for sensationalist headlines which portray India as an unreliable investment destination.

Media impressions are augmented by adverse credit ratings by professional agencies. Whilst the criteria adopted by such agencies are transparent, the results of the analysis are often baffling to the country being assessed. India faced a downgrading in Sept 2002 by Standard & Poor when the economy's fundamentals were very strong.

Professional agencies also offer assessments of political risks and these, too, influence FDI. Here, the risk criteria are not so well known. Although most often these are fair, there are instances of expatriate managers of investing MNCs being amazed at the immaturity of some of the reports emanating from such agencies.

Often, however, the actions of the Indian establishment serve to reinforce the perception of India as an investor-unfriendly country. Policy pronouncements at the Central Govt level often do not percolate down to the bodies responsible for implementation. Such bodies may be under the jurisdiction of provincial Government and the innate lack of accountability amongst sections of Indian bureaucracy can nullify even the most well-meaning policies.

There are many reasons for this negativity. Corruption is one of them, but also to be blamed are factors such as the difficulty in dismantling an over-regulated economy, inherent resistance to change, the absence of reward and punishment mechanisms in Indian officialdom, lobbying by affected Indian industry, safety-net provisions for the workforce and finally, the compulsions of an energetic democracy.

Expectations and Concerns:

At a recently concluded conference on FDI held in New Delhi by CUTS and sponsored by DFID and UNCTAD, a consensus seemed to emerge amongst Indian participants:

1. FDI into India was nowhere near its needs or potential. FDI levels would have to triple in the next 5 years if India was to attain its targeted growth rate of 8% p.a.

2. There still remained vestiges of resistance to FDI within the Indian establishment and the public at large. There was a need for effective advocacy groups to allay fears and permit more informed public opinion. Only civil society organisations can help dispel the complexes left behind by the East India Company.

3. The Government could play a much more positive role by being transparent and proactive in policy pronouncements. An atmosphere of secrecy and a Government which sporadically alters policy hardly promotes confidence.

4. Whilst FDI was eminently desirable, what was perhaps more important was a policy and regulatory framework which attracted investment and industrialisation as a whole, irrespective of whether this was foreign or domestic. FDI tended to flow in where the industrial environment was favourable and where the economy was strong.

In lay terms, the message that emerged was that it was more important for India to set its own house in order than to be concerned about whether or not FDI would flow in.