CHAPTER – III

FOREIGN INVESTMENT SCENARIO DURING THE PRE-REFORM PERIOD IN INDIA (1947–90)

Bombay Plan and Industrial Policy Resolutions of 1948 and 1956

When India attained independence in 1947, it became imperative to formulate an economic model for growth with social justice. Unlike many Third World countries, which attained freedom in the '50s and '60s, India had a strong industrial base. In 1947, the modern factory sector accounted for 10 per cent of national income. Yet, the Indian industrialist lacked the confidence, and the capital, to bring massive industrialisation to the country. And so, there was consensus among political leaders and industrialists that India should opt for a planned economy. This was articulated in the famous *Bombay Plan* of 1944-45 authored by leading Indian industrialist like Purushottamdas Thakurdas, J.R.D. Tata, G.D. Birla, Ardeshir Dalal, Sri Ram, K. Lalbhai, A.D.Shroff, and John Mathai. They advocated comprehensive land reforms, making production, in the agricultural sector cooperative-oriented, financing & marketing and state intervention to build infrastructure like power, telecom, roads, basic industries (like steel and cement) to spur sustained economic growth. The private sector would then cater to the demand, which this rapid State-controlled industrialisation would create.

The new nation had to choose it's own economic model. One model was the capitalist path of development, which was adopted by western countries such as the United Kingdom and the USA. But India was impressed by the success of the Five-year Plans of the Soviet Union, which contrasted with the severe economic crisis, which the US and other western countries suffered following the Great Depression of 1929. This led to a favorable political climate for a larger role for public sector enterprises (PSE).

Nehru's Statement on Foreign Capital

With the advent of freedom, the pressure for economic development in India necessitated a realistic approach towards foreign capital. The late Prime Minister Nehru made a statement in April 1949 giving three important assurances to foreign

investors: (i) India would not make any discrimination between foreign and local undertakings, (ii) Foreign exchange position permitting, reasonable facilities would be given to foreign investors for remittances of profits and repatriation of capital; and (iii) In case of nationalization of the undertaking, fair and equitable compensation would be paid to foreign investors.

The Industrial Policy Resolution of 1948 and 1956 as well as Mr. Nehru's statement on foreign capital constitute the core of the Government's policy on foreign capital. The Indian Government has recognized foreign capital as important supplement to domestic saving for the development of the country and for securing scientific, technical and industrial know-how.

FDI Policies from 1947 to 1980

During the three decades after India gained political independence in 1947, the Indian Government displayed a "stop-and-go" attitude towards foreign capital and its institutional form, transnational corporations. On the one hand, the Government sought to establish limits on the areas of industrial activity in which TNCs' could operate, and also to restrict the degree of foreign ownership of those operations. On the other hand, the Government wanted to draw foreign investment in the hope that it would provide technology and capital for industrialisation as well as boost foreign exchange reserves. Usually, the latter considerations prevailed. Initial post-independence hostility to foreign capital quickly changed to toleration. This was reflected in the shift from the Government's first Industrial Policy Statement of 1948, which maintained that only Indians should hold effective control of industrial concerns, to a 1949 statement which stated that the "Government would not object to foreign control of a concern for a limited period".

TNCs' investment steadily increased in subsequent years. Between 1948 and 1959, for example, the value of foreign investment in India more than *doubled*. In the manufacturing sector foreign investment *tripled*, with noteworthy increases in transport equipment, machinery, and chemicals and allied products. During the same decade, the share of the manufacturing sector in the total foreign capital increased from 28 to 38 percent. Foreign investment in petroleum grew almost seven times, with its share in the total foreign capital jumping from nine per cent to 26 per cent.

A small number of foreign companies rose to prominence in these years, including Firestone, Dunlop, and Bata Shoe Company. Hindustan Lever, subsidiary of the TNC Unilever, became India's biggest manufacturer of food products and toilet articles.

By the mid-1960s TNCs had assumed a dominant role in Indian big business, thanks partly to depleting foreign exchange reserves, which had encouraged the Government to liberalise its stance towards foreign investors. In 1966, of the largest 112 corporations in India (by assets), 62 were foreign owned or controlled. The assets of these 62 accounted for 54 per cent of the assets of all 112 companies. Moreover, many Indian firms were involved in technical collaborations with TNCs, and were dependent on them for machinery and spare parts. TNCs dominance was particularly evident in India's pharmaceutical sector, where by the early 1970s 80 per cent of production was controlled by foreign corporations including giants such as Ciba, Glaxo, Pfizer, Hoechst, and Bayer.

After devaluation of the rupee in 1966, which enhanced the rupee value of foreign currencies and allowed TNCs to establish operations in India with a relatively lower foreign exchange commitment, FDI inflows increased considerably, further strengthening transnationals' position in Indian industry.

While foreign investment inflows slowed after 1970, FDI continued to rise as TNCs reinvested profits which Indian foreign exchange rules prevented the TNCs from repatriating. Such rules notwithstanding, TNCs—especially US corporations, which were rapidly expanding in India – profited handsomely from their investments. However, TNC's profit and dividend repatriation as well as remittances of fees, royalties, and interest constituted a severe drain on Indian foreign exchange resources.

Concern about this drain and foreign economic domination generally led the Indian Government to pass the Foreign Exchange Regulation Act (FERA) in 1973. Among other measures, the FERA required foreign companies (with some exceptions) to dilute their non-resident shareholding to 40 per cent, essentially "Indianising" TNCs' subsidiaries. While some transnationals, most famously IBM and Coca-Cola, refused to abide by the FERA and took their operations out of India several years after its implementation, most TNCs chose to stay and sold their shares to Indians. These

TNCs actually benefited because their newly "Indianised" affiliates were able to expand and diversify without any of the restrictions, which had applied to foreign firms, notably those, which had limited foreigners' access to certain industrial sectors. Moreover, the FERA regulators usually permitted the TNCs to issue fresh shares rather than sell the foreign-held shares to Indians, thereby promoting a wide dispersal of the new shareholdings and allowing the TNCs to retain unchallenged managerial control.

Some analysts have suggested another reason why the majority of Transnationals complied with the FERA, namely that it offered them a defensive strategy at a point when TNCs were coming under criticism about the extent of their economic sway and political influence. By offering Indians a stake in their business, the TNCs were trying to legitimise their presence and protect their interests. "This is the functional role of the strategy of Indianisation", economist Dalip S. Swamy wrote in 1980. "It helps them [TNCs] to avoid the potential risk of being expropriated, to diversify their operations in the host country with local participation, and to release some capital which can be deployed in their parent countries or elsewhere for joint collaboration". Given the advantages the FERA presented to TNCs, it is unsurprising that a year after the Act's passage the Indian Government approved a record number of foreign licensing and equity linked joint venture proposals, with most of the approvals going to US-based companies.

In its statement on Economic Policy (November, 1977) the Janata Party laid the following guidelines regarding foreign collaborations:

"The Janata Party will not go in for foreign collaboration in areas where adequate Indian skills and capital are available. Whenever the need for foreign collaborations is felt in areas of high priority, emphasis should be on purchasing outright technical know-how, technological skills and machinery".

The process of Indianization of Foreign Branches (FB's) operating in the country and the dilution of foreign equity in other rupee companies, which FERA sparked off, brought about a drastic change in the organizational structure of the foreign controlled sector in India. One significant outcome was that all companies operating in the country (except foreign airline, shipping and banking companies) were incorporated

under the Indian Companies Act. This put a stop to the alleged tax-free repatriation of profits in the form of 'head-office expenses' by FBs. This provision vitally affected the tea plantation industry which was dominated by 114 British tea companies (FBs). Since the reorganization, the business of these FBs has been taken over by 45 companies incorporated in India with up to 74 per cent foreign equity[1]. A number of MNEs that were maintaining branch offices in India – to monitor investment opportunities and oversee their investments in other companies but without any manufacturing activity—had to wind-up. Therefore, the branch as a form of operation by foreign companies became virtually extinct except in the service sectors.

Another aspect of the enforcement of FERA was that of the 881 companies which sought RBI permission to continue their business only about 150 (including tea companies) were permitted to retain higher levels of foreign equity[2]. Only these companies remained within the ambit of FERA. Others diluted their foreign equity to 40 per cent as per RBI directives. These companies were now able to operate, expand, and diversify in any industry open to other local private firms. Thus, for most foreign companies FERA provided an opportunity to become 'Indian' and to expand. Hence, most of them readily agreed to dilute the foreign equity to 40 per cent[3]. That did not mean, however, that they ceased to be foreign controlled. First, the criterion of 40 per cent share holding was arbitrary. Effective control over a joint stock company can, sometimes, be exercised with as little as 10 per cent block share holding. Both the Monopolies and Restrictive Trade Practices Act (MRTP) and the RBI considered 25 per cent equity holding to be adequate for exercising effective control. Second, FERA dilutions in most cases were effected not by the sale of foreign held shares to Indian nationals but through the issue of fresh shares. This process of share allotment ensured that the new share holdings were as widely dispersed as possible. In addition, the clauses inserted in the Articles of Association just before the dilution of shares gave special rights to the foreign shareholders. Therefore, the dilution of foreign share holdings did not necessarily imply a reduction in foreign management control (See Chaudhuri (1979); Goyal (1979); Kumar (1982)).

FDI Policies during the 1980s

Just as the FERA began to be implemented, a doubling of crude oil prices on the international market in the late 1970s caused India's annual oil import bill almost to

quadruple, creating an immediate and acute foreign exchange crisis. In response, the Indian Government applied for and received what was the largest loan in the country's history from the World Bank/International Monetary Fund (IMF). This multi-billion dollar loan carried requirements, which worked powerfully to TNCs' advantage. As part of an "adjustment program" on which the loan was conditioned, the Government ended support to public sector industries. The Government also increased the number of industrial areas in which TNCs could invest; this included allowing public enterprises to enter into collaborations (with equity ownership) with transnationals. Imports of commodities and technology were liberalised. TNCs were permitted to increase their foreign equity, and export – and technology-oriented units were allowed 100 per cent foreign equity. TNCs were also allowed to place these export units anywhere in India. Additionally, the Government instituted other measures such as reducing corporate income tax, which encouraged foreign investment.

The result of these and other liberalising changes was a near three-fold increase in foreign collaborations, and an eleven-fold rise in Government approved foreign investment, between 1981 and 1985. Many TNCs including Suzuki, DuPont, Mitsubishi, Goodyear, and Seiko entered India during these years. While foreign collaborations declined slightly in the latter half of the 1980s, they were still at levels far above those before 1984, and between 1980 and 1989 overall, the number of foreign collaborations more than doubled. Especially after 1985, US-based corporations accounted for the largest amount of foreign investment as TNCs such as Westinghouse, Xerox, United Technologies, and Honeywell began collaborating with Indian firms.

Increasing participation of the TNCs in this period did not however lead to a decrease in the foreign exchange crunch. The strains on the economy increased as the larger imports effected by the TNCs led to an increase in trade imbalances. Compounding this problem was a dramatic escalation of the burden of external debt servicing.

The Opening Up of the 1980s

Almost throughout the 1970s the government's attention was focused on the enforcement of FERA. Towards the end of the decade, however, India's failure to significantly step-up the volume and proportion of manufactured exports in the

context of the second oil price shock began to worry policy-markers. It led to the realization that the international competitiveness of Indian goods was poor because of growing technological obsolescence and inferior product quality, limited range, and high cost. These were in part due to the highly protected local market[4]. Another limiting factor lay in the fact that marketing channels in industrialized countries were dominated by MNEs[5]. The government intended to deal with the situation by: (a) emphasizing the modernization of plant and equipment through liberalized imports of capital goods and technology, (b) exposing Indian industry to competition by gradually reducing import restrictions and tariffs and (c) assigning a greater role to MNEs in the promotion of manufactured exports by encouraging them to set up export-oriented units. This strategy was reflected in policy pronouncements made in the 1980s.

The Industrial Policy Statements of 1980 and 1982, for instance, announced a liberalization of licensing rules, a host of incentives, and exemption from foreign equity restrictions under FERA to 100 per cent export-oriented units. A major amendment of the MRTP Act in 1984 severely curtailed its scope. Some 25 industries were delicensed in 1985. It was decided that four more export processing zones (EPZ) should be set up in addition to the two existing ones, at Kandla (set up in 1965) and Santacruz (set up in 1972), to attract MNEs to start export-oriented units. The import-export policies of these years greatly liberalized the import of raw materials and capital goods by gradually expanding the list of items on the Open General License (OGL). In 1984 nearly 150 items and in 1985, 200 capital goods were added to the OGL list. Tariffs on imports of various capital goods were also slashed in 1985[6]. Restrictions on imports of designs and drawings were removed.

Parallel to the liberalization of trade policies there was an increasingly receptive attitude towards foreign investments and collaborations[7]. Policy guidelines were issued in November 1980 to streamline foreign collaboration approvals. The power to approve foreign collaborations not involving an outflow of more than Rs.5 million in foreign exchange and without any foreign equity participation was delegated to the administrative ministries[8]. In January 1987 this figure was further raised to Rs.10 million. Rules concerning payment of royalties and lumpsum technical fees were also relaxed[9]. Tax rates on royalties were reduced from 40 per cent to 30 per cent in the

1986 budget. A degree of flexibility was introduced in the policy concerning foreign equity participation, and exceptions to the general ceiling of 40 per cent on foreign equity were allowed on the merit of individual investment proposals[10]. To facilitate the flow of superior technology to existing industry the Cabinet Committee on Economic Affairs (CCEA) decided in December 1986 to permit foreign equity participation even in existing Indian companies employing superior technology. The equity participation under the new policy was, however, to be subject to certain conditions intended to make sure that this objective was fulfilled[11]. The employment of foreign nationals was also made much easier[12].

A number of steps were taken to remove procedural bottlenecks in 1989. Customs tariffs on general projects, and machinery and components were reduced by 10 per cent ad valorem and concessions in tariffs in the electronic sector were extended to 35 more types of equipment in the February 1989 budget. The cement and aluminium industries were decontrolled and broadbanding in respect of industrial licensing was extended to production of white goods. The Technical Development Fund (TDF) Scheme was liberalized in April 1988 and March 1989 to allow for import of technology and capital goods upto the foreign exchange equivalent of Rs.30 million with a provision for further relaxation in deserving cases[13].

Approvals for opening liaison offices by foreign companies in India were liberalized and procedures for outward remittances of royalties, technical fees, and dividends were streamlined. New procedures were introduced enabling direct application by a foreign investor even before choosing an Indian partner. The Finance Minister addressed a seminar on investment opportunities in India for US companies in New York in April 1989.

In order to expedite the flow of Japanese private investment and technology, the government announced the setting up of a 'fast channel' in May 1988 for their speedy clearance. The government also announced measures to streamline the remittance process and exempted export profits from income tax in order to attract Japanese corporations to produce in India for export, in the context of the strong yen[14]. The fast channel mechanism was subsequently also extended to other major home countries of foreign investors: first to erstwhile West Germany and later to USA, UK and France[15].

As a result of these measures the investment climate in the country gradually improved. An OPIC (Overseas Private Investment Corporation of the United States) mission visited India during February-March 1983 with representations from major US MNEs active in oil exploration, food processing, computers, solar and wind energy generation, pharmaceuticals, coal mining, gear manufacture, diamond cutting, machine tools, etc.[16]. In April 1985 the European Management Foundation organized a round table on India in New Delhi, which was attended by 140 top MNE executive. Subsequently, a number of international business delegations visited India to explore investment opportunities. As a result of the streamlining of procedures and liberalization of attitude the rejection rate in foreign collaboration approvals came down from 30 per cent to between 5 and 8 per cent[17].

Foreign Direct Investments in India: (1947-1990 : Pre Reform Period)

Prior to 1991, capital flows to India predominantly consisted of aid flows, commercial borrowing, and nonresident Indian (NRI) deposits (Table I). Direct investment was limited, averaging around $200 million a year over 1985-91. Foreign companies wishing to invest in India were generally restricted to 40 percent equity participation, subjected to requirements on technology transfer, and limited to priority areas. Foreign portfolio investment was channeled almost exclusively into a limited number of public sector bond issues, while foreign equity holdings in Indian companies were not permitted[18].

However a sequential study of FDI flow during the pre-reform period (1948-1990) is discussed and analyzed in brief.

Table-I
Pre-reform Period

	(Annual Average) 1985/86-1990/91
Capital account	7,349
Direct and portfolio investment	209
Net aid	2,525
Net commercial borrowing	1,945
Nonresident deposits	1,917
Other	753

Sources : Ministry of Finance; and IMF staff estimates

In mid-1948, when the first survey of India's international assets and liabilities was undertaken by the RBI, the stock of foreign investment in the country stood at Rs.2560 million, and was mostly of British origin. Bulk of this FDI was concentrated in export-oriented raw materials, extractive and service sectors. Tea plantations and jute accounted for a little over a quarter of the total FDI which together contributed half of India's exports; about 32 per cent was in trading and other services, 9 per cent in petroleum, and only about 20 per cent in manufacturing other than jute (Kidron 1965:3). By 1990, the latest year for which comparable official estimates are available, the stock of FDI in India had gone up to Rs.27050 million (RBI 1993). Not only the magnitude but the sectoral composition, sources, and organizational forms of investment have undergone considerable changes over this period.

Sectoral Distribution of FDI Inflow in India (1964-1990)

Table II summarizes the sectoral distribution of the stocks of FDI as at the end of the financial year 1964, 1974, 1980, and 1990. The most fundamental trend is the increasing importance of the manufacturing sector – from about a quarter of the FDI stock at the time of Independence and 40 per cent in 1964, to nearly 85 per cent in 1990. This jump has been at the cost of plantations, mining, petroleum, and services.

In all the non-manufacturing sectors the absolute volume of FDI as well as its share in the total stock declined during the period 1964 to 1980. Since 1980, however, plantations and services have marginally improved their share. Almost all the inflows of FDI to the country after 1964 were directed to the manufacturing sector, while disinvestments took place in other sectors. Though the total stock of FDI in the country stagnated during the late 1970s, in the manufacturing sector it steadily increased. This significant reorganization in the sectoral pattern of FDI in the country was stimulated by the government's selective policy. A few major nationalizations in the non-manufacturing sectors also contributed to it. Fourteen major banks, including one foreign owned, viz., the Allahabad Bank (Standard Chartered Group), were nationalized in 1969. The general insurance companies, a number of which were British controlled, were nationalized in 1971. Petroleum were nationalized between 1974 and 1976. In plantations, most of the Foreign Controlled Enterprises (FCEs) were foreign branches, which were obliged under FERA to Indianize themselves. The share of manufacturing in the total FDI stock in India was favorable even when

compared to the sectoral distribution of the total flow of FDI to developing countries. Thus, while manufacturing accounted for only 32, 64 and 42 per cent respectively of all American (1979-1981), British (1971-1978), and Japanese (1951-1980) FDI in developing countries (UNCTC 1983), it accounted for 87 percent of the FDI stock in India.

Within the manufacturing sector, the new investments were directed at technology-intensive sectors, such as electrical goods, transport equipment, machinery and machine tools and chemical and allied products (in particular, chemicals, medicines and pharmaceuticals). These four broad sectors accounted for nearly 74 per cent of total FDI in manufacturing in 1990 in contrast to 47.4 per cent in 1964. The rising importance of technology-intensive products in FDI stock was at the expense of traditional industries, such as food and beverages, textile products, and metal and metal products. As a result of the liberal policies of the 1980s, however, consumer goods industries, such as food and beverages, and textile products have also marginally improved their share in manufacturing FDI.

Table-II

Sectoral Distribution of the stock of FDI in India 1964-1990

(Resume = 100 million)

Industry	group	March 1964 Value	%	March 1974 Value	%	March 1980 Value	%	March 1990 Value	%
I.	Plantations	105.9	18.7	107.2	11.7	38.5	4.1	256	9.5
II.	Mining	4.7	0.9	6.4	0.8	7.8	0.8	8	0.3
III.	Petroleum	143.3	25.3	137.9	14.7	36.8	3.9	3	0.1
IV.	Manufacturing	229.3	40.5	625.6	68.4	811.6	86.9	2298	84.9
	1. Food and beverages	30.2	13.2	52.1	8.3	39.1	4.8	162	7.0
	2. Textile products	16.6	7.2	35.6	5.7	32.0	3.9	92	4.0
	3. Machinery & machine tools	15.7	6.8	42.1	6.7	71.0	8.8	354	15.4
	4. Transport equipment	15.0	6.5	32.1	5.1	51.5	6.3	282	12.3
	5. Metal & metal products	33.1	14.4	86.7	13.9	118.7	14.6	141	6.1
	6. Electrical goods	18.2	7.9	68.1	10.9	97.5	12.0	295	12.8
	7. Chemicals & allied products	60.1	26.2	203.7	32.6	301.8	37.2	769	33.4
	a. Chemicals	16.3	7.1	76.0	12.2	130.6	16.1	n.a.	n.a.
	b. Medicines and pharma-ceuticals	23.2	10.9	69.7	11.1	105.7	13.0	n.a.	n.a.
	c. Others	20.6	8.9	58.1	9.3	65.5	8.1	n.a.	n.a.
	8. Miscellaneous	40.4	17.6	105.0	16.7	100.0	12.3	203	8.8
V.	Services	82.3	14.6	39.8	4.4	38.5	4.1	140	5.2
	Total	565.5	100.0	916.9	100.0	933.2	100.0	2,705	100.0

Sources: Complied from RBI, 'India's international investment position', Reserve Bank of India Bulletin: July 1975, March 1978, December 1984, and April 1985; and RBI, 'India's Foreign Liabilities and Assets as on March 31, 1989', Reserve Bank of India Bulletin, August 1993, pp. 1031-1051.

Organizational Distribution of FDI Inflow in India (1964-1990)

Similar restructuring took place in the organizational form of FDI. In 1964, foreign branches accounted for 45.92 per cent of India FDI liability (see Table III). By 1990, their share had fallen to a mere 2.0 per cent of FDI stock. Among the companies registered in India (i.e., on MNCs), the trend was also one of increasing minority ownership. In 1964, only 11.65 per cent of FDI was held in the minority MNCs, their proportion increased to about 45 per cent by 1980. These trends in the organizational form of FDI – the decline in branches and the increasing acceptance of minority ownership by foreign investors—were the outcome of government policy, in particular Foreign Exchange Regulation Act 1973.

Table-III

Organizational Distribution of FDI Inflow in India, 1964-1990

(Rs. crores = 10 million)

Year	Foreign Branches		Foreign Controlled Rupee Companies (FCRC)		Total
	Value	%	Majority owned	Minority owned	
1964	259.7	45.92	239.9	65.9	565.5
			[42.42]	[11.65]	[100.0]
1974	241.6	26.45	470.4	201.4	913.4
			-51.5	22.05	[100.0]
1980	60.4	6.47	454.6	418.2	933.2
			48.71	-44.81	[100.0]
1990*	54.1	2.0	2,650.90		2,705
			[98.0]		[100.0]

Source: Nagesh Kumar, "Multinatiional Enterprises and Industrial Organizatioin", 1994, Pg.42

* Estimated share on the basis of distributioin for 1989.

Countrywise Inflow of FDI in India (1964-1990)

There has been a geographical diversification in the sources of FDI in India over the last three decades as the world has moved from British influence to American influence in the post war era. A considerable erosion of the dominance of the UK as a source of FDI has occurred (see Table-IV). In 1964 its share was nearly 77 percent, which has come down to about 49 per cent by 1990. The US has emerged as a major source of FDI, improving its share from 14.5 per cent in 1964 to 19 percent in 1990. Germany, Switzerland, Japan, Sweden and Canada, have also become significant sources of FDI to India. Germany accounted for nearly 10 per cent of the FDI stock in 1990 compared to just 1.13 per cent in 1964. Japan increased its share from 0.46 per cent to 4.9 per cent in the 1980s.

Table-IV

Home Country-wise Distribution of FDI, 1964-1990

(Rs. crores = 10 million)

Home Country	1964		1980		1990	
	FDI	%	FDI	%	FDI	%
UK	433.0	76.77	503.3	53.93	132.1	48.8
USA	82.3	14.53	196.4	21.04	518	19.1
Germany	6.4	1.13	65	6.96	267	9.9
Japan	n.a.	n.a.	4.3	0.46	132	4.9
Sweden	7.8	1.38	20.1	2.15	77	2.8
Switzerland	13.6	2.40	54.7	5.86	86	3.2
Canada	8.7	1.50	34.1	3.65	76	2.8
The Netherlands	n.a.	n.a.	n.a.	n.a.	36	1.3

Source:Nagesh Kumar, "Multinational Enterprises and Industrial Organisation", 1994. Pg.43.

In view of prevailing conditions, FDI failed to exhibit any degree of buoyancy during 1980's. For instance, while FDI, which in March 1980 amounted to Rs.933 crore, stood at Rs.1742 Crore as at the end of March 1987 and aggregated to Rs.2705 crore as on March 31, 1990. In other words, during 1980-90, FDI rose by Rs.1772 crore only. Although FDI in absolute terms had been increasing, its share in the total liabilities of the corporate sector revealed a declining trend[19].

The importance of FDI came down in India, particularly at a time when the FDI inflows into developing countries, as a proportion of total FDI inflows in the world increased. For instance, while the ratio of FDI inflows into the developing countries to the total FDI inflows of the world stood at 17.6 per cent in 1988, it rose to 32.2 per cent in 1992.The total stock of FDI as at the end of March 1991 was barely Rs.32.1 billion.

Foreign Collaboration Approvals (1948-1990)

The changing attitude of the government towards foreign investment and technology is reflected in the number of foreign collaborations approved in different periods. Table V summarizes three indicators for different periods; (a) average number of foreign collaborations approved per year; (b) proportion of foreign collaborations with equity participation; and (c) the volume of foreign investment approved. The

variations in these parameters across time reveal the nature of the change in government policy. The gradual liberalization of policy in the early post-Independence period in the wake of the economic crisis of the late 1950s resulted in an almost five-fold increase in the number of collaborations approved per year—from 50 during the period 1948-1958 to 297 during 1959-1966. Since foreign exchange was the major constraint during the period, a high (over 36 per cent) proportion of the collaborations approved were with financial participation. The restrictive posture adopted by the government during the 1967-79 period brought down the average number of approvals to 242. The squeeze on foreign financial collaborations was far more drastic, bringing their proportion down from 36.36 per cent during the period 1959-1966 to just 16.11 per cent during 1967-1979.

Table-V

Summary of Foreign Collaboration Approvals, 1948-1990

Period	Average no. of collaborations approved per year	Those with foreign equity: Average no. per year	Proportion in total	Average foreign investment involved per year (Rs million)
1948-58	50	n.a.	n.a.	n.a.
1959-66	297	108*	36.36	n.a.
1967-79	242	39	16.11	53.62
1980-88	744	170	22.8	930.84
1989-90	635	194	30.55	2,224.95

* on the basis of 1961 to 1966

Source : Nagesh Kumar, "Multinational Enterprises and Industrial Organization", 1994. Pg.44

The considerable liberalization of policy in the 1980s caused the average number of approvals per year to increase from 242 during the period 1967-1979 to 744 during 1980-1988. The increase in the number of financial collaborations per year was even sharper, their proportion in total approvals increasing from 16.1 per cent to 22.8 per cent. The average value of foreign investments approved per year increased by over 17 times from Rs.53.62 million to Rs.930.84 million. Political instability during the period 1989-1990 seems to have brought the average number of approvals down from 744 to 635 per year.

Import Liberalization and Overdependence on Debt Financing in 1980s

The monetary over-consumption spilled over to the external sector. This is reflected in the macro-economic imbalance in the external sector. Our import propensity is higher than our import capacity as per normal channels. The excess demand for foreign exchange has been persisting over the 6th and 7th plans. During the 6th plan the IMF loan helped to bridge the gap: during the 7th plan commercial borrowings and NRI deposit inflow along with deductions in reserves closed the gap. The excess consumption of foreign exchange has been financed by the growth of external debt.

The economy had been getting into debt, both internally and externally, at very high rates. Internally, the high level and the growth rate of debt have resulted in heavy interest and servicing charges. Consequently, non-plan expenditure has risen. The government's own lending rates to its borrowers were lower than those rates at which it borrowed. The servicing and interest burden on external debt is eating into export-earnings. It is necessary that the entire perspective on future debt be recast.

Therefore, while trade was liberalised during the 1950's and 1960's capital movements were regulated. It was only when, in the 1970's after the oil shock, inflation became an almost insoluble problem that capital immobility was abandoned. This was really a crisis of profitability but it put pressures to liberalise capital movements and this was done by USA, Germany and UK during the 1970's.

Many Latin American countries got caught in the global financial nexus during the 1970's when they borrowed petrodollars and failed to repay. India came late on to this problem; yet the end result was the same. It borrowed abroad but failed to reorient its economy in an export oriented way and got caught in 1991 in a debt crisis.

One of the cardinal errors of the 1980's was that India borrowed from abroad in the form of loans and debt rather than equity. This meant that the risk of failure was borne by India while with equity investment it would have been borne by the lender. The smart thing is to let FDI bring in the latest technology and combine it with India's skilled labour pool to export. This is the lesson of Bangalore; borrow the hardware and inject the software. Today technology comes embodied in the FDI along with the latest management techniques.

Regulation of foreign private capital in India can concretely be seen in terms of the changing attitude of the Indian Government towards this form of business in the country.

The regulatory administration can be seen to comprise of two distinct sets of policies. In the first set are those instruments, which provide the overall framework for industrial development and include the Five Year Plans and the statements related to industrial policy. The second includes specific legislations enacted at various points of time and which can be called the 'instruments' of policy initiatives.

Foreign Exchange Inflow and Outflow of MNCs in India during Pre-Reform Period

According to a Reserve Bank of India study, the net outgo in foreign exchange by foreign controlled companies in India was Rs.3860 million in the three years 1982-83 to 1984-85, compared with their actual investment in foreign exchange of about Rs.4000 million[20].

During the 1980s, total expenditure in foreign exchange by Hindustan Lever Limited (HLL) was about Rs.10.155 million, giving a net drain of Rs.1942 million[21]. Unilever's paltry investment of Rs.2.08 million in Hindustan Lever in 1932 is today worth over Rs.3.34 thousand million[22], all of which it can now repatriate to its "home" country. Cadbury India's foreign exchange outgo in 1990-91 was 7.3 times its earnings[23]. In the case of Castrol India, the amounts going out are over 60 times the inflow of foreign exchange[24].

Colgate-Palmolive India consistently declares dividends of over 50%. In 1984 it was 70% with 1:1 bonus shares, in 1991 it was 75% with 3:5 bonus shares. In comparison. Fortune 500 companies averaged dividends of 4.1% in 1991[25]. Thirty four US companies operating in India in 1987 had an average annual return after tax of 19.3% on net worth from 1975 to 1980. The net profit after tax and the net worth grew at an average annual compounded rate of 20.3 and 14.2%, respectively. Glaxo India increased its worth from Rs.139 million in 1971 to Rs.300 million in 1980, a growth of more than 100%[26].

BOP Crisis of 1990 -1991 and Its Causes

The external debt- crisis or the balance of payment crisis, which surfaced in Indian economy in late September 1990, was neither an accident nor a coincidence. Three factors, namely (i) fiscal imbalances and increase in internal debts (ii) large amount of current account deficits and increase in external debts and (iii) monetary expansion leading to high inflation cumulatively in second half of 1980's led to the crisis.

The gross fiscal deficit of the Central Government was 8.2 per cent of GDP during the second half of the 1980s, as compared with 6.3 per cent during the first half of the 1980s and 4 per cent in the mid-1970s. This fiscal deficit had to be met by borrowings as evident from Table VI. The internal debt of the government accumulated rapidly, rising from 35.6 per cent of GDP at the end of 1980-81 to 53.5 per cent of GDP at the end of 1990-91. The burden of debt servicing also mounted. Interest payments increased from 2 per cent of GDP and 10 per cent of the total central government expenditure in 1980-81 to 4 per cent of GDP and 19 per cent of the total central government expenditure in 1990-91. It is now obvious that any growth process based on such borrowing was simply not sustainable. The underlying fiscal crisis was bound to create a situation where the balance of payments situation would become unmanageable and inflation would exceed the limits of tolerance.

In the second half of the 1980s, current account deficits widened, India's development policy emphasis shifted from import substitution toward export-led growth, supported by measures to promote exports and liberalize imports for exporters. The government began a process of gradual liberalization of trade, investment, and financial markets. Two sources of external shocks contributed the most to India's large current account deficit in 1990/91. The first shock came from events in the Middle East in 1990 and the consequent run-up in world oil prices, which helped precipitate the crisis in India. In 1990/91, the value of petroleum imports increased by $2 billion to $5.7 billion as a result of both the like in world prices associated with the Middle East crisis and a surge in oil import volume, as domestic crude oil production was impaired by supply difficulties.

Second, the deterioration of the current account was also induced by slow growth in important trading partners. Export markets were weak in the period leading up to

India's crisis, as world growth declined steadily from 4.5 percent in 1988 to 2.25 percent in 1991.

In addition to adverse shocks from external factors, there had been rising political uncertainty, which peaked in 1990 and 1991.

India's balance of payments in 1990/91 also suffered from capital account problems due to a loss of investor confidence. The widening current account imbalances and reserve losses contributed to low investor confidence, which was further weakened by political uncertainties and finally by a downgrade of India's credit rating by the credit rating agencies, Commercial bank financing became hard to obtain, and outflows began to take place on short-term external debt, as creditors became reluctant to rollover maturing loans. Moreover, the previously strong inflows on nonresident Indian deposits shifted to net outflows.

As a consequence, the current account deficit doubled from an annual average of $2.3 billion or 1.3 per cent of GDP during the first half of the 1980s to an annual average of $5.5 billion or 2.2 per cent of GDP during the second half of the 1980s. These persistent deficits were inevitably financed by borrowing from abroad. The result was a continuous increase in the external debt, which, as Table VII shows, rose from $23.8 billion or 14.3 per cent of GDP at the end of 1980-81 to $62.3 billion or 22.8 per cent of GDP at the end of 1990-91. Consequently, the debt service burden also rose from 7.9 per cent of current account receipts and 14.9 per cent of export earnings in 1980-81 to 21.7 per cent of current account receipts and 29.8 per cent of export earnings in 1990-91. These strains, which mounted over the years, stretched to breaking point on account of the Gulf-War. The balance of payments lurched from one liquidity crisis in mid-January 1991 to another in late-June 1991 and came to the verge of collapse. On both occasions, foreign exchange reserves dropped to levels, which were not enough to finance imports even for a fortnight[27].

The vulnerability of the balance of payments was accentuated by two other factors. First, it became exceedingly difficult to roll over the existing short-term debt in the range of $ 6 billion because of adverse international perceptions of the situation and the overnight borrowing in international capital markets was as much as $2 billion.

Second, non-resident deposits, where the outstanding amount then was more than $10 billion, leveled off in September 1990 with a modest net outflow of $0.3 billion in the period October 1990 to March 1991 and a massive net outflow of $1.3 billion in the period April 1991 to September 1991.

The rapid pile up of external debt and the increased burden of debt servicing ultimately eroded international confidence in India's capacity for repayment.

The price situation also came under mounting pressure. The rate of inflation, in terms of the wholesale price index, climbed from less than 5 per cent in 1985-86 to more than 10 per cent in 1990-91 as evident from Table VIII.

Table-VI

Fiscal imbalances and internal debt of the central government (as a percentage of GDP at market prices)

Year	Gross fiscal deficit	Revenue deficit	Internal debt	Interest payments	Interest payments as a percentage of central government expenditure
1980-81	6.1	1.5	35.6	2.0	10.0
1981-82	5.4	0.2	35.0	2.0	10.9
1982-83	6.0	0.7	40.1	2.2	11.5
1983-84	6.3	1.2	38.7	2.3	12.4
1984-85	7.5	1.8	42.0	2.6	12.9
1985-86	8.3	2.2	45.5	2.9	12.3
1986-87	9.0	2.7	49.8	3.2	13.5
1987-88	8.1	2.7	51.8	3.4	15.2
1988-89	7.8	2.7	51.7	3.6	16.4
1989-90	7.9	2.6	53.2	3.9	17.4
1990-91	8.4	3.5	53.5	4.0	19.0

Source: I. For gross fiscal deficit, revenue deficit and internal debt : Reserve Bank of India, Annual Report, 1991-92.
ii. For interest payments as a percentage of GDP: Ministry of Finance, Economic Survey, 1990-91 and 1992-93.
iii. For interest payments as a proportion of total central government expenditure : Ministry of Finance, Economic and Functional Classification of the Central Government Budget, annual issues.

Source : Deepak Nayyar, Economic Liberalization in India, Centre for Studies in Social Sciences, Calcutta.

Table-VII

Current Account Deficit and External Debt during Pre-Reform

Year	Current account deficit as a percentage of GDP	Medium and Long-term External Debt end-of-year in US $ million	as a percentage of GDP	Debt servicingas a percentage of Exports	Current Account Receipts
1980-81	1.2	23.8	14.3	14.9	7.9
1981-82	1.4	24.3	14.2	13.5	7.7
1982-83	1.3	27.9	15.6	14.6	8.7
1983-84	1.1	31.1	16.0	17.2	10.3
1984-85	1.2	31.9	17.1	19.8	11.7
1985-86	2.3	37	17.4	26.7	15.9
1986-87	2	43.8	19.4	39.4	31
1987-88	1.9	50.8	19.5	41.3	26.4
1988-89	2.6	53.5	21.1	38.9	25.4
1989-90	2.2	57.7	21.6	31.1	21.5
1990-91	2.3	62.3	23.8	29.8	21.7

Source: I. For current account deficit : Reserve Bank of India, Report on Currency and Finance, annual issues.

ii. For medium and long-term external debt : Report of the Economic Advisory Council, The Current Economic Situation and Priority Areas for Action, Government of India, New Delhi, December, 1989, P.S-9 (for the period 1980-81 to 1983-84); and Reserve Bank of India, Annual Report 1991-92, p.214 (for the period 1984-85 to 1990-91).

iii. For debt servicing : Economic Survey, annual issues and Report on Currency and Finance, annual issues.

Notes: a. The data on medium and long-term external debt reported in Table 2 include external assistance from bilateral or multilateral sources on government account and non-government account, drawings from the IMF, external commercial borrowing and outstanding non-resident deposits.

b. The data on debt servivcing in Table 2 are derived from balance of payments statistics as the sum of amortization payments and interest payments. The figures on debt servicing reported by the Ministry of Finance or the Reserve Bank of India for this period underestimate the burden by a significant proportion because of the incomplete coverage of external debt statistics.

c. The current account deficit-GDP ratios and the external debt GDP ratios are based on the rupee values of the current account deficit during each fiscal year and the outstanding medium and long-term external debt at the end of each fiscal year, expressed as a percentage of GDP at current market prices (data on GDP are from CSO, National Accounts Statistics).

d. The debt-service indicators are based on the rupee value of debt servicing expressed as a percentage of the rupee value of exports and of current account receipts (data on exports and current account receipts are from RBI balance of payment statistics).

Source: Deepak Nayyar, Economic Liberalization in India, Centre for Studies in Social Sciences, Calcutta.

Table VIII

Monetized deficits, monetary expansion and inflation

Year	Monetized deficit as a percentage of GDP	Money supply (M3) percentage growth per annum	Inflation per cent per annum
1980-81	2.6	18.3	17.7
1981-82	2.0	12.8	9.3
1982-83	1.9	16.7	4.9
1983-84	1.9	18.1	7.6
1984-85	2.6	18.9	6.4
1985-86	2.4	15.9	4.5
1986-87	2.4	18.6	5.7
1987-88	2.0	16.0	8.2
1988-89	1.6	21.9	7.5
1989-90	3.0	19.4	7.5
1990-91	2.8	15.1	10.3

Source: Reserve Bank of India, Annual Report and Report on Currency and Finance, annual issues.

Note: The data on inflation are based on the average-of-period increase in the wholesale price index.

Concluding Remarks

The study on different policy mechanisms during pre-reforms period for regulating foreign private capital in India shows that the mechanisms by themselves were quite ineffective in controlling the growth of foreign controlled companies in the country. In the case of the Licensing system, as we had seen, the Government had no machinery to curb misuse of licences issued. Even when misuse of licenses were brought to light, the Government was found warning in taking punitive action against the offending companies. The scope of Government regulations in respect of foreign private capital, in particular, was reduced progressively in the four decades since 1947. The reduction of controls over foreign private capital was done primarily because the Government saw foreign companies as conduit of two crucial inputs, viz., finance and technology, for its industrialization process. This was made clear by Prime Minister Nehru in his 1949 policy statement. While Nehru emphasized the need to augment domestic savings with foreign capital, the later policy makers have sought capital from foreign companies not in a direct form, i.e., in the form of equity participation, but in the form of a trade surplus. Foreign private capital was expected to promote exports and to meet the foreign exchange requirements of industrialization. In respect of technology, several policy documents and utilization of indigenous technologies[28].

A consensus began to build in the late 1970s, and especially after 1984, that India would have to liberalise its economy to reduce controls, create adequate resources for social programs, and modernise its infrastructure and manufacturing sector. GDP growth accelerated to over 5 per cent during the 1980s and there was a marked increase in exports of manufactured goods especially, in the second half of the 1980s.

However, macroeconomic imbalances became a serious problem. The budget deficit of the Government rose steadily from 6.4 percent of GDP in fiscal 1981 to over 9 percent in fiscal 1991, while the current account deficit rose from 1.7 percent to 3 percent of GDP. In 1991, the Government's domestic debt had risen to 56 percent of GDP. Besides, India's external debt rose from US$20 billion in 1981 to US$70 billion in 1991, while the debt service ratio increased from 10 percent to 29 percent. The Government that came to power in June 1991 inherited an economy in crisis.

The outmoded economic policy and industrial policy, in particular, led firstly, to the emergence of an enormous administrative paraphernalia in both New Delhi and State capitals, with corruption at all levels. Secondly, it encouraged industrialists and businessmen to get involved in wheeling and dealing with corrupt officials in order to obtain licenses for investments and for the expansion of industrial capacity. Once they obtained these, they did not have to worry about actually producing the goods, or about the quality of the products as the domestic market was protected, and here they could virtually sell anything with no risk of a competitor. Whilst industrial efficiency was at a very low level because of too many Government regulatory controls, fiscal imbalance over a long period were tending India towards financial bankruptcy in the international market. Fiscal deficits peaked at 8.4 per cent of GDP in 1990-91, and forced the Government of India to adopt a policy of massive deficit financing, which led to an acceleration of a high rate of inflation.

At the same time, the current account deficit and the persistent balance of payments problem put a great pressure of India's already large external debt. In brief, the Indian economy was on the brink of a disaster by mid-1991. The only way to save the economy was to take decisive steps to reverse the old and ingrained policy of "economic isolation" which led to corruption and inefficiency and forced the economy to deviate from the path of "sustainable development".

In the period ending with the 1980s, India maintained a selective approach towards foreign direct investment (FDI). The overall policy environment during the period 1947-1990 has been considered as the key factor in determining the low level of foreign investment in the country. The specific instruments of policy that were widely regarded as impediments to the expansion of foreign capital in the country were: industrial licensing under the Industries Development & Regulation Act, 1951(IDRA); the size consideration under the Monopolies & Restrictive Trade Practices Act, 1969(MRTPA); limits on the level of foreign share placed by the Foreign Exchange Regulation Act, 1973(FERA); high rate of taxation; restrictive labour laws; and inadequate patent protection.

The acute foreign exchange shortage in mid-1991 forced the government to seek the support of the International Monetary Fund (IMF). Largely due to IMF's pressure, India then began a major process of economic reform.

Notes and References :

1. *See the list of FERA companies, and replies to Lok Sabha unstarred question no.4921, 18 September 1981.*
2. *See replies to Lok Sabha unstarred questions nos.2100 and 2214, 9 March 1984.*
3. *For instance, 72 companies diluted their foreign equity even before specific FERA directives were issued to them. Another 54 companies, which were permitted to retain over 40 per cent foreign equity volunteered to dilute to 40 per cent. See Lok Sabha question no.4921, September 1981.*
4. *See, for instance, Government of India, Ministry of Commerce, Committee on Export Strategy (Tandon Committee), New Delhi, 1980.*
5. *Ibid.*
6. *See Multinational Business, No.3 (1985: 10-17).*
7. *See Business America, 7 February 1983.*
8. *See The Hindustan Times, 1 June 1981.*
9. *See Financial Express, 20 January 1987.*
10. *Government of India, Industrial Policy Statement, July 1980.*
11. *The Economic Times, 10 December 1986.*
12. *India Today, 31 December 1988; 121.*
13. *Ministry of Industry press note no.2 (1)/89-TDF, 17 March 1989.*
14. *Business Standard, 31 May 1988.*
15. *Monthly Newsletter-Indian Investment Centre, October 1989.*
16. *Business America, op. Cit.*
17. *India Today, op. Cit.*
18. *International Monetary Fund, "India: Economic Reform and Growth", Washington DC, December 1995, Pg.41.*
19. *Reserve Bank of India Bulletin September 1996, Pg.425.*
20. *Anon, "Foreign Direct Investment: Foreign Exchange Drain", Economic & Political Weekly, 24 August 1991,p.1940.*
21. *Hindustan Lever Employees Union, Bombay, 30 April 1991.*
22. *Anon, "Hindustan Lever Ltd.", The Times of India, 29 January 1990.*
23. *Anon, "Cadbury India: Growing Competition", Economic & Political Weekly, 1 February 1992, p.180.*
24. *Anon, "Will it Maintain Growth?", Business Express, 2 September 1991.*

25. *Anon, "Carla's Comments 'Misleading", Chemical Weekly, 29 October 1991, p.119.*

26. *Savur, Manorama, "Involvement of Business Houses in Rural Development: A Case Study", Economic & Political Weekly, 30 May 1987, pp M41-44.*

27. *The level of foreign exchange reserves was $1.2 billion in mid-January 1991 and $1.1 billion in end-June 1991; see Reserve Bank of India, Bulletin, monthly issues.*

28. *See, India, Estimates Committee (1971-72), Nineteenth Report : Industrial Licensing, Fifth Lok Sabha, 1972.*