INAUGURAL ADDRESS BY HON'BLE MR. JUSTICE R.C.LAHOTI,
FORMER CHIEF JUSTICE OF INDIA
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"Legal Aspects of Foreign Direct Investment"
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I. Introduction

1. The importance of Foreign Direct Investment and its legal aspects is most relevant today. In the initial stage of liberalization, India was facing the financial crises for meeting external commitments. During 1990-1991, India had to pledge its gold before World Bank to repay foreign debts as India had only $ 1 billion foreign exchange reserves, at the same time, the immediate liability of external payment was more than $ 25 billion. Therefore we had to follow liberal economic policy for the inflow and outflow of foreign investment and depreciation of Indian rupees by 300% in comparison to dollar from rupees 8 to rupees 28 per dollar. The foreign investors were attracted by the policy and started investing their funds in India as India had and has potential for the growth and diversification of business. Since then India has made remarkable progress in the field of foreign direct Investment but there are many challenges and issues which need to be resolved, to promote and attract foreign direct investment.

2. Foreign Direct Investment means an investment made by a company or entity based in one country, into a company or entity based in another country. Entities making direct investments typically have a significant degree of influence and control over the company into which the investment is made. Open economies with skilled workforces and good growth prospects tend to attract larger amounts of foreign direct investment than closed, highly regulated economies.

3. The policies we adopted after India's balance of payment crisis in 1991 resulting in increasing liberalization and privatization of our economy led to intensified globalization of our country. Globalization has been prevalent since the growth of civilization but the intensity with which it is present now was never before. In respect to the present subject the precise definition of Globalization can be *"the integration of one nation's economy with the economies of the other nations of the globe."*

4. Foreign direct investment is one of the measures of growing economic globalization. Investment has always been an issue for developing economies such as India. The world has been globalizing and all the countries are liberalizing their policies for welcoming investment from countries which are abundant in capital resources. The countries which are developed are focusing on emerging markets such as India where there is availability of abundant labour, scope for production, and chances of achieving higher profits. Therefore, Foreign Direct Investment (FDI) has become a battle ground in the emerging markets like India. The objective behind allowing FDI is to complement and supplement domestic investment, for achieving a higher level of economic development and providing opportunities for technological upgradation, as well as access to global managerial skills and practices. Other Asian economies such as China have implemented open door policies during 1980's but India liberalized its policies in 1991.

5. In recent years, emerging market economies (EMEs) are increasingly becoming a source of foreign investment for the rest of the world. It is not only a sign of their increasing participation in the global economy but also of their increasing competence. FDI triggers

technology spillovers, assists human capital formation, contributes to international trade integration, helps create a more competitive business environment and enhances enterprise development. All these contribute to higher economic growth. Existence of real business opportunities is one of the key factors in attracting FDI. FDI influences growth by increasing total factor productivity and, more generally, the efficiency of resource use in the recipient economy. Technology transfers through FDI generate positive externalities in the host country. In order to reap the maximum benefits from FDI, there is a need to establish a transparent, broad and effective enabling policy environment for investment and to put in place appropriate framework for their implementation.

6. The evolution of Indian FDI can broadly be divided into three phases classified on the premises of the initiatives taken to induce foreign investments into the Indian economy:

i. The first phase, between 1969 and 1991, was marked by the coming into force of the Monopolies and Restrictive Trade Practices Commission (MRTP) in 1969, which imposed restrictions on the size of operations, pricing of products and services of foreign companies. The Foreign Exchange Regulation Act (FERA), enacted in 1973, limited the extent of foreign equity to 40%, though this limit could be raised to 74% for technology-intensive, export-intensive, and core-sector industries. A selective licensing regime was instituted for technology transfer and royalty payments and applicants were subjected to export obligations.

ii. The second phase, between 1991 and 2000, witnessed the liberalisation of the FDI policy, as part of the Government's economic reforms program. In 1991 as per the 'Statement on Industrial Policy', FDI was allowed on the automatic route, up to 51%, in 35 high priority industries. Foreign technical collaboration was also placed under the automatic route, subject to specified limits. In 1996, the automatic approval route for FDI was expanded, from 35 to 111 industries, under four distinct categories (Part A–up to 50%, Part B–up to 51%, Part C–up to 74%, and Part D-up to 100%). A Foreign Investment Promotion Board (FIPB) was constituted to consider cases under the government route.

iii. The third phase, between 2000 till date, has reflected the increasing globalisation of the Indian economy. In the year 2000, a paradigm shift occurred, wherein, except for a negative list, all the remaining activities were placed under the automatic route. Caps were gradually raised in a number of sectors/activities. Some of the initiatives that were taken during this period were that the insurance and defence sectors were opened up to a cap of 26%, the cap for telecom services was increased from 49% to 74% , FDI was allowed up to 51% in single brand retail. The year 2010 saw the continuation of the rationalisation process and all existing regulations on FDI were consolidated into a single document for ease of reference.

II. Policy Reforms Post-1991

7. Policy reforms after the macroeconomic crisis of 1991 marked a turning point in India's economic history for two reasons. First, fiscal deficit driven external payment crisis with a dip in foreign exchange reserves to below US$ 1 billion in July 1991 drew a crisis resolution strategy to restore macroeconomic stability. Sharp correction in fiscal deficit-GDP ratio and reduced monetisation of deficits contributed towards restoring macroeconomic balance by the mid-1990s. The reduced dependence of fiscal deficit on monetisation enabled

the Reserve Bank of India to reduce its statutory pre-emption of funds from banks, thereby freeing resources for the private sector. Second, simultaneously efforts were made towards wide ranging structural reforms encompassing areas of trade, exchange rate management, industry, public finance and the financial sector.

8. At present, only five industries are under licensing, mainly on account of environmental, health, safety and strategic considerations. Only two industries are reserved for the public sector, *viz*, atomic energy and railway transport. Reservation of industrial products for the small scale sector is still a lingering issue. However, the definition of small scale industry (SSI) has been changed to facilitate modernisation and now only 20 items are reserved for manufacturing in the small scale sector. Foreign Direct Investment (FDI) up to 100 per cent is allowed under the automatic route in most sectors, with a few exceptions.

9. Comprehensive fiscal reforms covered tax reforms, restructuring of public sector undertakings and improving fiscal-monetary coordination before eventually carrying these reforms forward under rule based fiscal consolidation path from 2004-05, which was interrupted by the global financial crisis in 2008-09. Reduction in customs duties over the years reflected India’s commitment towards converging towards the ASEAN levels over the medium-term. The monetary policy framework was designed in a way which would encourage greater FDI in India.

10. In the financial sector, the objective was to provide operational flexibility and functional autonomy to banks and other financial institutions so that they could allocate resources more efficiently. The key objective of the external reforms was to move to a more open trade regime by correcting for the implicit anti-export bias. Moreover, there was a greater recognition of the need to view trade policies, exchange rate policies and industrial policies in an integrated manner. In pursuance of this, the administered exchange rate regime gave way to a flexible market-determined system.

11. The trade policy reforms comprised withdrawal of the quantitative restrictions on exports and imports, phasing out of the system of import licensing and lowering the level and dispersion of nominal tariffs so as to bring them on par with the East Asian economies. The peak customs tariff rate was progressively brought down from 150 per cent in 1991-92 to 10 per cent by 2008-09. The liberalization of restrictions on various external transactions led to current account convertibility under Article VIII of the Articles of Agreement of the IMF in 1994.

12. With respect to capital account liberalization, India embarked on a gradual and well sequenced opening up of the capital account. The active capital account management framework was based on a preference for non-debt creating capital inflows like foreign direct investment and foreign portfolio investment. The capital account is virtually free for non-residents and resident corporates with some restrictions on financial institutions and higher restrictions on resident individuals.

III. Policy Challenges

13. The draft approach paper for the Twelfth Five Year Plan (2012-17) released in August 2011 targets an annual GDP growth rate of 9 per cent. This is challenging but not unattainable. Why? Because India has already achieved an average growth rate of about 9 per cent during 2004-08 which was interrupted by the global financial crisis. Subsequently,

average growth has dropped by about one percentage point to 7.8 per cent during 2009-11. In 2011-12, the terminal year of the Eleventh Plan, growth is expected to be about 8 per cent. Hence, growth will have to be raised by an additional percentage point per annum which is challenging because it will require a conducive global environment and policy reforms at home. While there are several tasks to be addressed, I will focus on five major issues.

V. Road Map Ahead

14. First, our country will have to raise agricultural productivity and diversify agriculture to feed its own population. The food entitlement has increased with the public employment guarantee programme (MGNREGA) which guarantees for 100 days of employment to one member of each family in the rural areas. This has also given better bargaining power to labour and consequently the overall wage rates have gone up raising the demand for food.

15. Second, the fact that 53 per cent of overall work force is still engaged in the agricultural sector – whose share of GDP has shrunk considerably – is worrisome. A substantial part of this labour force will have to be ejected from agriculture not only to improve the productivity in agriculture but also in the overall economy. It is unconceivable that they can all be absorbed gainfully in the services sector. Hence, industrial employment will have to expand so also the relative contribution of industry.

16. Third, to support industrialization and increased economic activity, there is a need to step up investment in infrastructure. The assessment of the Planning Commission suggests an investment of 45 trillion (US $ 1 trillion) over the Twelfth Plan (2012-17). Given the large requirement of long-term funds, financing infrastructure would be a big challenge. Besides budgetary support, the bulk of the funds has emanated from banks. However, channelling domestic and foreign financial savings of this scale into infrastructure will require developing the domestic private corporate debt market. Apart from the need for substantial financial outlays for infrastructure, there are several non-financing constraints: particularly land acquisition delays need to be addressed to avoid time and cost overruns.

17. Fourth, credit markets have, historically, played a crucial role in sustaining growth through efficient intermediation of funds between savers and investors. Although our country has a well-diversified financial system, and several measures for financial inclusion have been taken in the recent past, credit penetration continues to be relatively low in comparison with several other developed and emerging market economies. The Reserve Bank has embarked on a plan of making available basic banking services to all habitations of population of over 2000 by 2012 through a combination of brick and mortar branches and a system of business correspondents (BCs).

18. Fifth, empirical evidence suggests that the threshold level of inflation is in the range of 4-6 per cent. On inflation I remember a famous quote by Swam Ewing that

> *"Inflation is when you pay fifteen dollars for the ten-dollar haircut you used to get for five dollars when you had hair."*

Hence, without bringing inflation down from the current level it will be difficult to sustain a high level of growth. This will require greater monetary-fiscal coordination and alleviation of supply constraints, particularly in agriculture.

IV. Conclusion

19. Envisioning India's emergence as a major economic power in the world, Dr. Manmohan Singh in his Union Budget 1991-92 speech that launched wide ranging economic reforms had quoted Victor Hugo's saying,

"no power on earth can stop an idea whose time has come".

Ever since, there has been no looking back as India launched wide ranging structural reforms and has made significant economic progress over the past two decades. India's industrial environment has become more competitive and open, infrastructural gaps have been sought to be bridged through public-private initiatives with both domestic and foreign sources of funding, current account has become fully convertible while capital account is virtually free for non-residents. The policy environment has become more enabling with rule-based commitment on fiscal policy and considerable instrument independence for operation of monetary policy. As statutory pre-emption's were reduced and interest rates were deregulated, banks gained operational autonomy for commercial lending. As a result, India's per capita income, which had taken four decades to double by 1991, doubled thereafter in 15 years and is likely to double again in 10 years by 2017-18. If India could maintain the current pace of growth it will lift millions out of poverty and enrich the global economy. While India has come a long way, maintaining the current pace would itself be challenging and require continued reform efforts.

20. As it has been rightly said by Ludwig von Mises, that

> *"Manufacturing and commercial monopolies owe their origin not to a tendency imminent in a capitalist economy but to governmental interventionist policy directed against free trade and laissez faire.",*

Thank You.

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