UNIT 19 FOREIGN CAPITAL

Structure

19.0 OBJECTIVES

After reading this unit, you shall be able to:

- state the role of foreign capital in the growth process of a developing economy;
- differentiate between different types and sources of foreign capital;
- describe the government of India's policy towards foreign capital;
- state the current nature of foreign investment in India;
- explain the foreign investments by Indian companies;
- identify the weaknesses in the government policy and make relevant suggestions in this regard.

19.1 INTRODUCTION

Spread of technology and recent technological advances have opened up the economies world over and hence the role of foreign capital has increased. For a developing economy, foreign capital is all the more critical because it fills: (i) investment saving gap (ii) technology gap (iii) foreign exchange gap. Hence, in this unit we shall discuss the various issues related to the foreign capital.

In the simplest model of economic growth, growth is a function of investment that is of additions to the stock of capital. Investment in turn depends on the rate of savings, which is a function of household savings and retained earnings of companies and enterprises. When average per capita income is low, savings is constrained. A way of overcoming the effect of low income is to import capital. This imported capital, or foreign capital, adds to investment and thus helps raise the rate of growth of the economy. Of course, this is based on the assumption that there is sufficient skilled labour of the type required for the invested capital to be used in production.

There are two important points in the above relationship between foreign capital and growth of a developing economy. The first point is that foreign capital can add to the capital available for investment, helping to overcome the limited savings of the developing economy. The second point is that foreign capital does not come just as a sum of capital but brings with it certain technologies, embodied in equipment, and methods of production. The second point then extends the reason for seeking foreign investment beyond a scarcity of capital to that of acquiring new technologies and methods of production. These new technologies and methods of production may not be new in a global sense, but new for the developing country concerned.

A third point in the role of foreign capital is that of increasing the stock of foreign exchange for buying new plant and equipment. A developing country will not have a well-developed machinery or capital goods producing sector. For instance, there may be textile mills which use spinning and weaving machinery. But the country may not have any plants that produce spinning and weaving machinery. It will then have it import such capital equipment, if available domestic savings is to be transformed into investment. With limited exports, foreign capital could help provide the foreign exchange required for investment.

19.2 IMPORTANCE OF FOREIGN CAPITAL

To sum up the above reasons for foreign capital: developing countries may face three gaps — a savings gap, a foreign exchange gap and a technology gap. All these three gaps could be reduced by foreign capital. We now look at the simple mathematics of the savings gap.

19.2.1 Savings Gap[1]

The gap between desired investment and domestic savings can be filled by foreign capital. The following simple algebra will show how this happens.

The basic proposition of national income accounting is

$$Y = C + I + (X - M) \qquad \ldots (1)$$

Where Y = Gross national product (total spending), C = Consumption, I = Investment, X = Exports of goods and services plus income received from abroad, and M = Imports of goods and services plus income paid abroad. The total spending is equal to consumption plus investment plus the excess of foreign receipts over foreign spending.

The total spending, Y, is either consumed, C, or saved, S; which gives

$$Y = C + S \qquad \ldots (2)$$

Since total spending equals total income, combining (1) and (2), gives

$$C + I + (X - M) = C + S \qquad \ldots (3)$$

The above equation can be manipulated as follows: subtract C from both sides, and shift (X – M) to the other side, reversing the sign. This gives

$$I = S + (M - X)$$

This is a simple relationship. Investment is constrained by the domestic savings plus any net receipts from abroad (M – X). Since export receipts are constrained

[1] This section has been taken from Unit 18 of Block-5 of course MEC-005 on Indian Economic Policy.

(export pessimism) the only way for $M - X > 0$ is through capital inflows from abroad.

The above then is the manner in which foreign capital inflows can increase investment in a developing country beyond that made possible by its domestic savings. Foreign capital will increase the total financial resource available for investment.

But there is yet another route to increase the rate of investment beyond domestic savings. This is through remittances from the country's workers working abroad. India, for instance, has benefited greatly from the remittances of Indian workers in the Gulf countries and West Asia in general.

19.2.2 Foreign Exchange Gap

The foreign exchange gap is based on there being a ceiling on export earnings such that they are insufficient to finance required purchases of plant and equipment which are required for investment. The basis of 'export pessimism' is discussed in another section. Here it can be pointed out that there is likely to be such a constraint when a country exports have a very low elasticity of demand, so that an increase in supply may not result in an increase in export earnings. This may occur in an earlier stage of an under-developed country's development process. But, as experience, has shown developing economies, even what are now called Least Developed Countries (LDCs) may be able to get a share of low-skill, labour-intensive production segments of, for instance, garments' manufacture.

19.2.3 Technology Gap

More important than the foreign exchange gap is the technology gap. The industrialised countries have developed technology for manufacturing and even agriculture for that matter. In order to increase productivity developing economies need to import these technologies. This gap, however, can be met in a number of ways. One is that of outright purchase on the market. But it is possible that the foreign company owning the technology may not be willing to sell it. Selling it will give it just a one-time profit. But if the firm could use that technology to invest in a developing country as a Multinational Company (MNC) then there could be stream of profits. In such a situation, the MNC would be needed to invest capital and acquire a stake in the investing company or carry out Foreign Direct Investment (FDI).

Check Your Progress 1

1) State how foreign capital contributes to economic growth?

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2) What do you mean by saving gap? How does foreign capital help to fill this gap?

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3) Explain the nature of technology gap faced by a developing economy.

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19.3 TYPES OF FOREIGN CAPITAL

When referring to foreign capital it is usually foreign private capital that is meant. Foreign public capital, such as from multilateral organisations (the World Bank, ADB, etc.) or from bilateral organisations (USAID, UK's DFID, etc.) are not included in this. But in terms of increasing the amount of capital available for investment, such international public capital has the same effect as foreign private capital.

Foreign private capital is of two types — direct business investment also known as Foreign Direct Investment (FDI) and portfolio investment, mainly Foreign Institutional Investment (FII). FDI is investment in a company in the host country. It obviously sets up a MNC, since its operations would be in more than one country. It is investment that could be market-seeking, trying to utilise opportunities in the domestic market. It could also be efficiency-seeking, in the sense that the MNC tries to reduce its cost of production by utilising lower wage labour in the developing country. A third reason for FDI could be to get access to scarce resources, minerals and the like.

A MNC usually tries to integrate its operations across different locations. It might produce raw materials or parts in one country and transfer them to be assembled or manufactured in another country. In this trade of intra-firm trade, there could be opportunities for transfer pricing, keeping prices low in inputs supplied from the host country in order to increase profits in the country of origin.

The other form of foreign capital is that of portfolio investment, usually by FIIs but could also include supplier's credit, invested in host country companies. Nowadays the extent of FII investment is quite large. Non-residents do not usually invest individually, but through investment funds of different types. Some of these investment funds are quite large public funds, such as pension funds of retired teachers, retired government officials and the like. This type of foreign capital is invested in search of higher rates of return. With developing country economies and their stock exchanges now doing better than their counterparts in developed countries, there is a lot of FII capital seeking investment in developing economies. Most of such capital is invested in stock markets.

There is a major difference between FDI and FII. The former is relatively stable, since there is an investment commitment to the host country. The MNC sets up a plant, or distribution and marketing operation and is expected to stay in the host country for a reasonably long time. Short-term variations in rates of return are not likely to lead to a withdrawal of the capital invested.

On the other hand, FII investment is targeted at maximising returns in the short-term. If stock exchange values drop sharply there could well be a withdrawal of such FII investment, and its being shifted to another country. The possibility of quick withdrawal and reinvestment of portfolio investment has led it to be dubbed 'hot money'. There can be too much inflow of such hot money when a country's stock exchange is doing well and too much outflow of the same when a country's stock exchange is doing badly. Thus, FII investment would tend to be pro-cyclical, rather than contra-cyclical; it would tend to intensify cyclical movements, rather than dampen them.

19.4 FOREIGN INVESTMENT IN INDIA

19.4.1 Trends

Foreign investment, both FDI and Portfolio Investment, was quite tiny in 1991, a total of just $103 million. It grew substantially with the opening up of the economy and in 2006-07 reached $29.2 billion. Over the last few years, with the slow-down in the US, EU and other developed economies, while the Indian economy has continued to grow at more than 7 per cent per annum, foreign capital investment in India has also grown. Capital will tend to move into countries where rates of profit are higher. Combined with this is the tendency mentioned in the preceding section for many manufacturing and service segments to shift to lower cost centers, such as China and India. Consequently over the last four years, foreign investment has been in excess of $60 billion a year.

But the total of foreign investment has also become more volatile, almost entirely due to portfolio investment. As the table below shows, there was net portfolio outflow of $13.8 billion in 2008-09. This is when the financial crisis hit the developed economies, and many financial institutions would have withdrawn investments from India and other developing countries, in order to strengthen their balance sheets at home.

While portfolio investment is volatile, FDI is much steadier. FDI depends not on current and short-term returns but on the longer-term prospects of the economy. Thus, FDI has continued to grow. Only in the current year (2010-11) in line with the overall slow-down of investment in the Indian economy, there has been a slow-down of FDI too, from $37.7 billion in 2009-10 to $30.3 billion in 2010-11.

Table 19.1 : Foreign Investment in India (US $ billion).

Year	FDI	Portfolio Investment	Total
1990-91	97 million	6 million	103 million
2000-01	4.0	2.7	6.7
2006-07	22.8	7.0	29.8
2007-08	34.8	27.2	62.1
2008-09	37.8	–13.8	23.9
2009-10	37.7	32.3	70.1
2010-11	30.3	31.4	61.8

Source: RBI, Database on Indian Economy, accessed on 27-03-12.

Note: Figures for 1990-91 are in million US$. For all subsequent years the figures are in billion US$.

19.4.2 Sectoral Distribution of FDI

India has a very high share of services in GDP, around 55 per cent. This is more like the share of services in developed countries. In comparison in middle to high income countries of East and South-east Asia, other than Japan, the share of services to GDP is around 35 per cent. With such a large share of services in GDP and in GDP growth in India, it would be expected that services would also dominate in FDI. Services accounts for the largest share of FDI, up to $27.6 billion in 2010-11.[2] This is more than twice as much as in the sector with the next

[2] All figures in this and the next section are from Department of Industrial and Policy Research Factsheet, reported in www.rediff.com>Business, accessed on 27 March 2012.

highest FDI. FDI in services has been in both of the two broad categories of trade, hotel, restaurants and transport, and in the banking, insurance and real estate.

These categories of services are followed by computers, which includes both software and hardware, with $10.8 billion. In the computer segment, given India's prominence in the provision of software services, software dominates hardware in investment. Telecommunications is next with just a little less, $10.6 billion. Software services and telecommuncations also fall within the broad category of services, which means that overall almost $50 billion is concentrated in various forms of services. Foreign investment is motivated by profits, as domestic investment too is and one would expect it to be predominantly in the more profitable and faster-growing sectors.

FDI in the manufacturing sectors is highest in housing and real estate ($9.6 billion) and construction ($9.4 billion). Adding up these two segments gives this part of the infrastructure sector, with a total FDI of 19 billion, which is second only to the services investment of $ 27.6 billion. Again, given India's infrastructure deficit, it is no surprise that FDI is strong in this area.

The first manufacturing segment to enter the top 10 FDI sectors is automobiles, with $6.1 billion. Most international auto majors manufacture in India. More recently automobile manufacture has not only been for the growing Indian domestic market, but also for export. India has emerged as a leader in the middle to small car segment. Tatas with the Nano has even created a new car segment of the ultra cheap car. FDI in automobiles reflects both the fast growth of the Indian middle class market and India's international role in the middle to small car segments. Power, metallurgy and petroleum and natural gas make up the other major sectors of FDI.

A broad classification of FDI by sectors is given in Table 19.2. From the above description and the table below we can see that FDI in India is primarily aimed at benefitting from the growing Indian market. Unlike in many other countries, exports is not the main factor motivating FDI.

Table 19.2: FDI by Sectors in 2009 (per cent).

S. No.	Sector	Per cent Share of FDI
1)	**Services**	**69.78**
	of which	
	Housing, Real Estate and Construction	20.82
	Telecommunications	9.50
	Agricultural Services	4.84
	Information and Broadcasting	2.90
	Computer Software	2.55
2)	**Manufacturing**	**21.41**
	of which	
	Automobile Industry	4.94
	Electrical Equipment	2.91
	Metallurgical Industry	1.74
	Chemicals	1.69
3)	**Energy**	**7.90**
4)	**Others**	**0.91**
5)	**Total**	**100.00**

Source: K. S. ChalaptiRao and Biswajit Dhar, 2011, 'India's FDI Inflows: Trends and Concepts', ISID, Working Paper, 2011/1.

19.4.3 Countries of Origin of FDI in India

When looking at the countries of origin of FDI in India, at the top of the list is a most unexpected entry – Mauritius. This island in the Indian Ocean is the largest source of foreign investment in India. It is not that Mauritius has such a surplus of capital. But the island has very low tax rates, and a treaty for avoidance of double taxation with India. It is what is known as a 'tax haven'. Thus, companies are registered in the Mauritius in order to benefit from its low tax rates and invest in India.[3]

Mauritius is followed by Singapore. Investment from Singapore is mainly in the sectors of telecom, off-shoring of services, power and oil refineries. The growing investment from Singapore in India and other countries of Asia is part of the trend of Asian regional investment. Traditional investors in India, are the USA, UK, Japan, Germany and other European countries.

Check Your Progress 2

1) Distinguish between Foreign Direct Investment (FDI) and Foreign Portfolio Investment?

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2) Why has the foreign investment been more volatile?

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3) List the top 10 Indian sectors attracting FDI.

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19.5 NEW TENDENCIES IN FOREIGN INVESTMENT

It was mentioned that foreign investment often sought efficiency by being able to utilise cheaper Indian labour or to sell in the Indian market. Recently, a new form of foreign investment has come up and that is of MNCs setting up research

[3] Many newspaper reports suggest that some money illegally taken out of India, comes back for investment in India through the Mauritius route.

centres in India. IBM, Microsoft, GE, Sony-Ericsson, and many other MNCs have set up research centres in India. This also utilises a form of cheaper labour-Indian professionals and scientists could be paid less than their counterparts in the developed countries.

Research requires not just individual scientists but whole groups of such scientists. India is by now well-known for the substantial supply of well-qualified scientists and technicians. MNC research centers in India set up to tap into this supply are responsible for a lot of the patents that have been acquired out of India in the IT sector. The growing strength of India is knowledge-based sectors, such as software and R&D, is manifested in growing foreign investment in these sectors.

But there is yet another reason for such investment in India, as also China for that matter. This is to be part of developing products for the high volume, but low priced Indian markets. Tata's Nano car is a good example of such a low-cost car developed for the Indian market. GE, the US MNC, has developed low-cost portable ECG machines. This is a reversal of the usual trend of developing products in the advanced countries and then adapting them for the developing countries. Now, some products are being developed for the developing country markets and then being adapted for developed country markets.

The investment of foreign capital in setting up research centers in India (and China) needs to be noted as a new trend in MNC operations in developing economies.

A reverse trend of foreign investment by Indian companies, Indian MNCs, should also be noted. After the growth of healthy foreign exchange reserves, Government of India has allowed foreign investment by Indian companies. Some major Indian companies, such as Tata and Mahindra and Mahindra, have undertaken substantial FDI. Tata Steel-Corus, Tata Motors acquisition of Jaguar/Land Rover are important examples. Airtel has acquired telecommunication units in Bangladesh and Africa. The Indian IT majors have all set up branches in many countries and also acquired particular technology capabilities. They are either to acquire technology and brand names as in the case of Jaguar Land Rover or to acquire access to markets, as in Mahindra and Mahindra's investment in the US.

The third set of Indian foreign investments is targeted at securing access to raw materials. Public sector companies, such as ONGC and OiI India, are the major investors in this area; but there are also private investors, such as Ambani Industries in petrochemicals. Altogether, these are a set of expanding MNCs of Indian origin. Taking other developing economies into account, this is part of growing South-South investment relations. Are they the same as the old neo-colonial relations of domination, or are they different?

19.6 GOVERNMENT OF INDIA'S POLICY TOWARDS FOREIGN CAPITAL

As with external trade, India's policy on investment by foreign capital can also be divided into two phases, pre- and post-1991. Before 1991 there were numerous restrictions on FDI. MNCs were required to have Indian partners and the MNCs could only up to 40 per cent of equity. This policy led, for instance, to the exit of IMB and Coca-cola from India at one time. But after 1991 51 per cent invest by FDI in equity was allowed, which meant that the MNC could have a controlling interest. Majority FDI was allowed automatically in 'priority' sectors, including (intermediate and capital goods). For other FDI beyond the limits permission had to be taken from the Foreign Investment Promotin Board (FIPB).

But there still are some restrictions on FDI. Majority FDI in retail is allowed only in single brand shops. For multi-brand retail, such as WalMart, the government did recently (in late 2011) announce a change of policy. But the wide-spread opposition to this policy has forced the government to suspend it. There still is considerable distrust of foreign capital in India.

Non-investment Foreign-controlled Production

One of the issues that is much discussed with regard to FDI is foreign control of economic activities in the host country. But, it should be noted that foreign influence over host country economic activities can well occur without any capital investment at all. This occurs in a number of new forms of relationships — contracted manufacturing and farming, outsourcing of services, and franchising or licensing. One increasingly frequent form of global production is that of contracted production within global production networks (GPNs) or global value chins (GVCs). In GPN production the sellers do not sell their product as commodities on the market, nor are they produced through MNC branches. Rather the producers make them under contract to the buyers. This is frequently the case with many labour-intensive segments of production, such as manufacture of garments or footwear.

In such contracted global production, the buyers specify the output in great detail. The design, colour, fabric, types of accessories are all very specified. Delivery times are fixed. Obviously, prices too are fixed. In this form of chain or network production the buyers do not have to undertake any investment in production facilities. Forms of governance, as they are called, enable the buyers to keep control of the output.

Such contracted production has extended beyond the relatively simple areas of garments and leather products to complicated electronic products, such as Lap-top and other computers. Initially, the buyers or contractors disclaimed any responsibility for labour conditions in such contracted production, maintaining that it was the responsibility of the sellers or producers. But, given that the profits from such contracted production provides enormous profits to the buyers, civil society movements in the developed countries have insisted hat the buyers should have responsibility for these labour conditions.

This responsibility for at least some labour conditions has led to forms of corporate governance, in addition to state governance of labour conditions. The very-well publicised issue of labour conditions has been that of child labour. The result of media pressures, civil society campaigns and government has largely led to the elimination of child labour from the main factory or workshop centers of production. But investigations show that this has not eliminated all child labour from the supply chains; rather in those tasks that are carried on within the home, tasks such as hand embroidery or trimming, there continue to be a substantial incidence of child labour.

The main point, however, is that there are forms of foreign control over production that do not involve foreign capital investment. The growth of forms of contracted production that provide foreign buyers control without capital investment need to be noted.

19.7 CRITICAL EVALUATION OF THE POLICY RELATING TO FOREIGN CAPITAL

Since opening up of the economy, both in trade and to foreign capital, there has not been a major economic crisis nor a take-over of the economy by foreign capital. In fact, there has not been a flood of foreign capital, whether FDI or portfolio investment. With a growing domestic market, there has been an increase in FDI from just about $5 billion a year before 2005 to $20 billion and $40 billion before the 2009 economic crisis and $50 billion in 2009-10. There have been substantial swings in FII – when the developed economies slowdown, capital moves to emerging economies, including India and vice versa. But, as the RBI Annual Report (2011-12) points out, India has been able to manage flow changes of the magnitude of $100 billion in a year, without too much turbulence in domestic markets.

But there is big difference between FDI in India and South-east countries and China. In those countries FDI contributed substantially to the countries' exports. It possibly added to the total investment in the country, by requiring supplementary domestic investment and serving a market that was not accessed before the FDI. But in India there has been little FDI in the export sectors. Indian exports continue to remain based on Indian capital. FDI has largely taken place to access the Indian domestic market, as in automobiles. It is likely that some other Indian investment would have taken place, had this FDI not occurred. In this sense, it is likely that this FDI has been a substitute for Indian investment, that is, it has crowded out Indian investment. There is an important benefit of such FDI in that it increases competition in the domestic market and thus promotes efficiency. On the whole, however, foreign capital, in such a large economy as India, is neither a panacea for all ailments, nor a menace to sovereignty.

Finally, does FDI involve import or upgradation of technology? In a relatively closed economy, and one where domestic capital is not very well-developed, FDI may not involve the latest technology. In fact, it is more likely to involve the import of older vintages of technology. Older plant and equipment could well be shipped to developing country locations through FDI. But FDI in a more developed economy, such as India's, is unlikely to involve much of older technologies. The very fact that other companies could import the latest technology and secure a cost advantage would discourage the import of older technology. On the other hand, since the developing countries may not have already invested in the older technology, it is very likely that the latest technology will in fact be imported. This clearly has occurred in important sectors, like telecommunications. Asian and even more African countries with poor landline systems, have moved straight to mobile telecommunications, by-passing some conventional stages of technology development. Of course, the extent to which the most modern technology is imported or not depends on the extent of monopoly. Further, a company seeking to enter an already established sector, is likely to have to import more recent technology in order to gain a competitive advantage. In general, the more competitive and developed an economy, FDI is more likely to result in upgradation of technology.

Check Your Progress 3

1) Discuss the recent new tendencies being observed in the foreign investments by MNCs.

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2) State the various forms for non-investment foreign controlled production.

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3) Do you think foreign capital is a panacea for all ailments?

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19.8 LET US SUM UP

Foreign capital contributes to growth of a developing economy by reducing three types of gaps i.e. saving gap, foreign exchange gap and technological gap. Foreign capital can be public such as multilateral organisations (the World Bank, ADB) or private. Again foreign private capital is of two types — Foreign direct investment and portfolio investment. Foreign capital has grown substantially with opening up of the economy. However the total foreign investment have become volatile due to portfolio investment. Several new forms of investment (i.e. setting up of research centres by MNCs securing access of raw materials, etc.) have emerged.

Before 1991, there were numerous restrictions on FDI. But after 1991, 51 per cent investment by FDI was allowed. Majority of FDI was allowed automatically in priority sectors. There are forms of foreign control over production that do not involve capital investment like outsourcing of services, franchising or licensing, global production networks etc. On the whole, However, foreign capital in large economy like India, is neither a panacea for all ailments, nor a menace to sovereignty.

19.9 KEY WORDS

Saving Gap : The difference between the required rate of investment and the actual rate of saving available in an economy.

Trade Gap : The difference between the expenditure of foreign exchange and receipts of foreign exchange in transactions of goods and services.

Multinational Corporations : A business organisation which owns or controls income generation assets in more than one country, and in so doing produces goods or services outside its country of origin.

Foreign Direct Investment : More generally refers to the value of the MNC's investment in equity shares of an enterprise in a foreign country.

Portfolio Investment : Refers to equity holdings by a non-resident in the recipient country's joint stock companies.

19.10 ANSWERS OR HINTS TO CHECK YOUR PROGRESS EXERCISES

Check Your Progress 1

1) See Section 19.2
2) See Sub-section 19.2.1
3) See Sub-section 19.2.3

Check Your Progress 2

1) See Section 19.3
2) See Sub-section 19.4.1
3) See Sub-section 19.4.2

Check Your Progress 3

1) See Section 19.5
2) See Section 19.6
3) See Section 19.7