Components of foreign capital economics essay

ASSIGN BUSTER

FOREIGN DIRECT INVESTMENT- FDI is in the form of investments directly made in industry or any other fields of economic activity of a country by foreign industrial houses or Multinational Corporations (MNCs) with the sole objective of earning profit.

Since the investment is made by companies in their private capacity, it is also called Private Foreign Capital[1].

Such investments have long term commitments.

2) PORTFOLIO INVESTMENT- It is made by foreign financial companies called Foreign Institutional Investors (FIIs) in tradable securities.

These FFIs enter India's capital markets to buy and sell securities with an objective of earning speculative gains[2].

ADVANTAGES OF FOREIGN CAPITAL-

Foreign Capital or FDIs by the MNCs can help the underdeveloped or developing countries in the following ways[3]–

PROVIDE TECHNICAL KNOWLEDGE- The underdeveloped and the developing countries are technologically backward. They lack sufficient resources to carry on research and development to upgrade their technology. Foreign intervention serves as an agent for the transfer of superior technology. They have provided with advanced technical knowledge, better marketing techniques and sophisticated manufacturing processes.

PROVIDE LINKAGE EFFECTS- They provides linkage effects to the host country which are both forward and backward.

BUILD KNOWLEDGE BASE- and further help to develop human resources which helps to raise productivity.

CREATE EMPLOYMENT OPPORTUNITIES- by setting up branches and subsidiaries in the host countries, they provide the host country with various forms of employment.

REDUCE INEQUALITY BETWEEN NATIONS- Foreign capital brings about development in the underdeveloped and developing countries and reduces the economical inequalities between the countries[4].

RAISE COMPETITION- helps to develop a healthy competitive environment between various countries.

DISADVANTAGES OF FOREIGN CAPITAL[5]–

1) CAN AGGRAVATE MONOPOLISTIC TENDANCIES- by creation of sectors having few linkages with the rest of the economy and introduction of inappropriate production and consumption patterns.

2) CAN BRING IN WRONG TECHNOLOGIES- MNCs can bring in inappropriate capital intensive technologies and stimulate inappropriate production patterns[6].

3) CAN RAISE INCOME INEQUALITIES- by promoting the interest of a small group of well- paid organized workers and displace the less skilled labor.

4) CAN STIMULATE WRONG CONSUMPTION PATTERNS- by diverting resources away from food products or other necessities to manufacturing of sophisticated products to satisfy the demands of local elites.

5) MAY NOT REINVEST PROFIT-in the host country and divert all the profit to the parent country.

6) MAY HARM LOCAL PRODUCERS- by importing materials from international affiliates rather than buying from indigenous suppliers. This will retard the growth of the local firms.

7) REDUCE FOREIGN EXCHANGE- substantial import of intermediate and capital goods and repatriation of profits will reduce foreign exchange earnings in the long run[7].

8) PROMOTES REGIONAL DISPARITIES- It can create prosperity and development in some areas while some areas remain underdeveloped.

INDIAN GOVERNMENT’S POLICY TOWARDS FOREIGN CAPITAL[8]

Pre-1991 Policy-

The foreign investment policy maintained that foreign capital should not be allowed to enter and where it already existed, to expand[9].

However since 1956, there was inflow of foreign capital into a number of industries such as drugs, tires, automobiles etc. due to high rate of projected growth under 2nd Plan and lack of indigenous technological capability[10].

Three enhancements – MRTP Act1969[11], Indian Patents Act 1970 and FERA 1973[12]tipped the scales against foreign investment

The Foreign Exchange Regulation Act (FERA) of 1973 controlled the foreign direct Investment in India. Larger shareholdings in some industries where

foreign technology was needed were permitted but were under strict control. FERA regulated foreign firms, most of them were compelled to dilute foreign equity and foreign branch companies were obliged to Indianise their shareholdings or fold up.

Two major companies Coca Cola and IBM were ordered to wind up business in 1977.

In auto- industry, the Government refused to allow the US giant[13], general motors to acquire one- third of the equity in the Birla owned Hindustan Motors on the grounds that there was no foreign equity in other car manufacturing units.

By 1980, a foreign exchange crisis surfaced and the new government took a large loan from IMF. The IMF’s conditions led to some liberalization in foreign investment policies and foreign investment was welcomed in many closed areas . The government decided each proposal by careful analysis. Only Suzuki was welcomed in car manufacturing.

Reforms of 1991[14]:

Since the starting of the adjustment program in 1991, a large role has been envisaged for foreign investment foreign investor’s interest in a country may result in financial flows either in the form of direct investment or portfolio investment[15]. Portfolio investment takes the form of acquisition of tradable securities either in the primary or secondary market. Foreign Direct Investment is preferred primarily for the reason that it directly helps to

increase the capital formation of the recipient country. Portfolio investment involves transfer of financial resources only.

FERA 1973 has been amended and restrictions placed on foreign companies by the FERA have been lifted. The policy enables free flow of foreign investment and technology. The main provisions are-

a) Foreign equity holding up to 51% by international trading companies are allowed.

b) It provides for automatic approval to foreign technology agreements in the case of priority industries within certain guidelines.

c) In high technology and high investment priority industries where imported capital goods are required, automatic clearance (up to 51% will be given)

d) The guidelines on Euro issues and external Commercial Borrowing to international capital markets.

3) In 1998-99, projects for electricity generation, transmission and distribution, roads and highways , ports and harbors , vehicular tunnels and bridges were permitted foreign equity participation up to 100% under the automatic route[16].

The restrictions on FERA companies with regard to borrowing of funds and raising deposits in India as well as taking over and creating interest in business in Indian companies have been removed[17].

And the use of foreign brand names for goods manufactured by domestic industries has been allowed

Government has allowed Foreign Institutional Investors (FFIs) to invest in Indian Capital markets by registering with SEBI and getting RBI approval.

4) Foreign Investment Implementation Authority (FIIA) was established within the Ministry of Industry to ensure that approvals for foreign investment, including NRI investments, are quickly transferred to projects.

5) Outflows by residents are highly controlled; foreign portfolio investments by residents are forbidden. Indian banks have been allowed to extend credit / noncredit facilities to Indian Joint Ventures / Wholly Owned Subsidiaries abroad subject to certain conditions.

6) India has joined hands with many other developing nations to form the MULTILATERAL INVESTMENT GUARANTEE AGENCY (MIGA)[18]with an aim to promote foreign investment. As a result of the liberalization of the foreign investment policy and other reforms in the trade and industrial sectors, the foreign investment picture has undergone a significant change . It is reflected in the higher value of approvals and the rising trend in the actual inflows[19].

Foreign investment in India has increased from US$133 million in 1991-92 to US $ 45 billion in 2007[20].

11th FIVE YEAR PLAN (2007-2012)[21]

India is now regarded as one of the best performing emerging market country capable of sustaining rapid growth over the next two decades, providing appropriate policies are put in place to deal with existing constraints on growth This has created a favorable impression among foreign

investors though there are complaints still about the ease of doing business. Most of the major international companies are now operating in India and many have announced ambitious expansion plans[22].

There has been steady liberalization of the FDI policy. Though some key service sub sectors are still subject to FDI ceiling and restrictions apply on a few business services and retail services there is continuing progress. . The FDI limit has been eliminated in all areas of manufacturing sectors and in the majority of sub sectors in the services sector . The country also remains on course on its policy of encouraging capital flows in a cautious man[23]

Indian companies with minority foreign ownership might have to face some problems with the introduction of Foreign Direct Investment as the government might seek to plug the loophole that allows sector specific foreign investment.

Any company that has more than 50% ownership will be considered as a domestic company under the current Foreign Direct Investment policy[24]and all the investments made by any such company is going to be considered as Indian investment.

Under the Prevention of Money Laundering Act, the foreign retailers have to make a declaration that they will not undertake any activity detrimental to India's interest[25].

Products imported in India from anywhere in the world even including China have to face import tariffs which will make them unattractive as compared to the local products[26].-

The farmers have the say that they will only be benefitted by Foreign Direct Investment in retail if the government makes it mandatory for the retailers to purchase 75% of their products directly from the farmers.

There is no doubt in the fact that the present mandi system that is prevalent in our country is not a 100% profit deal for the farmers they have to face many loses in their way in the form of transportation, broker commission and quality parameters.

Presently what is happening in India is that a product that will be sold by a farmer for Rs 1 will be sold at the mandi for 2 rupees and the same product will cost 3 rupees if it reaches the consumer through a retailer. Instead of using the foreign retailers to avoid this problem the Indian government should rather first take steps to invest money and infrastructure in the improvement of the manufacturing, transportation, storage and supplying services.

This will be more beneficial for the growth of Indian farmers without an foreign invasion.

The government’s decision to allow FDI in retail is a bailout package for the domestic corporate houses whose existence is under a threat now. In this country where there are more than 5 crore traders and around 20 crore people who are dependent on this retail business for their livelihood have been grossly ignored by the government’s decision.

The government is giving following viewpoints in favor of this sensitive and debatable issue.

-According to the government The Foreign Direct investment in retail will enhance employment opportunities in the agricultural and marketing sector and they say there will be creation of a minimum of three million jobs in the retail sector in the coming three years[27].

-According to the policy, it is mandatory for the foreign retailers to invest at least $100 million out of which half the amount has to be invested in back-end infrastructure which includes cold chains, refrigeration facilities, transportation, packing and processing . This will to eliminate the unnecessary loses that are presently being faced by the farmers. Due to lack of storage facilities there is a significant loss of agricultural products and it leads to wastage of food products every year[28]. This will have a good impact on the food inflation that is currently being faced by the country.

There is no doubt that it is good to be a reformist for bringing about growth and development one has to keep changing their ways and methods as per the changing times but every change is not a reform. In fact changes which may end up hurting domestic interests are really counter reforms.

In recent years , both small and organized retails have grown harmoniously. A significant investment is being made year after year. The pace at which domestic retail is growing is modest and it is able to co-exit with small retail. However, at this stage if international retailers are permitted the consequences will be adverse.

The first consequence will be an adverse impact on domestic manufacturing. Domestic retailers source domestically. International retailers operate on the principle of buying internationally at the cheapest cost. Majority items to be

sold by international retailers are going to be sourced from cheaper manufacturing economies like China.

Clothes, shoes, toiletries and other items of daily use are not likely to bear Indian signature. And this will lead to ma fall in jobs in the manufacturing sector in India.

The first step that the government needs to take is reforms in the manufacturing sector so as to enable us to develop into low cost manufacturing economy.

For this we need to improve infrastructure, low-cost utilities, and competitive interest rates and trade facilitation.

Once these reforms bring down the cost of our manufacturing goods, we can expect global retailers to source domestically . in the absence of these reforms, international retailers will be selling the products of low cost economies, leading to an adverse set back to our already challenged manufacturing sector. The Indian retail industry is still at nascent stage and it is not the correct time for modernization of retail trade

The character of Indian economy is service sector oriented. The latest NSSO survey shows a loss in employment. Self -employment continues to be the largest single source of bread earning in India.

Agriculture and retail are the largest job providers in India.

It is a major debatable topic that international retail is going to give additional jobs or is it going to displace the existing ones?

If purchasing power increases with the expansion Indian economy, it will reflect in the co-existence of structured organized domestic retail and small retail International retailers with deeper pockets will displace existing jobs in the retail sector rather than creating additional jobs.

A fragmented market is always in consumer interest. A consolidated market restricts the consumer’s choices.

Thus if the number of establishments is reduced and consumer options are eliminated, structured retail is hardly likely to serve consumer interests.

It can even lead to international retailers with deeper pockets to first sell at low prices, eliminate competition, and then exploit the consumers as they will not be left with any other choice but to purchase the same product at a higher cost than before. This will further lead to inflation. The consequences of predatory pricing can always be felt.

The Chinese example is thoroughly misconceived . The international retailers like Wal-Mart source their products from China which they also sell in China and other large number of countries.

China gains hugely because its products are sold all over the world.

There is one other total misconception that infrastructures like cold chains will develop only when international retailers enter India. Cold chain is not a rocket science or some technology that cannot be developed in India. It is the duty of the Indian government to make efforts to develop the cold chains.

It seems bizarre that in order to set up a chain of cold storages it can be suggested that food distribution chain of India be handed over to corporations controlled by foreign entities.

The farm gate to the factory gate argument is based on the logic that once middle men are eliminated the farmer will get more and the products will become cheaper.

The only agricultural product in the domestic market which currently follows the farm gate to factory gate principle is sugarcane. If only the market forces operate without the help of the state advised price, the cane growers would have been put to starvation

(Foreign Direct Investment in retail cannot be introduced merely as a knee jerk response because the government has to first take steps to start economic reforms. The Centre needs to do a little more homework focusing on harmonizing existing infrastructure and human resources with the architecture and sourcing of resources before making policy announcements.

India is one of the largest democratic of the world , so when many states have opposed Foreign Direct Investment , then also the government is not taking everyone into account and are rushing into taking decision which is not just being opposed by the opposition but also by its own allies like Trinamool Congress and DMK

The comment given by the State Department Spokesman Mark Toner “ We welcome India’s decision. We think economic reforms such as these will further strengthen business to business ties between the two countries”

But what we fail to understand is this measure will strengthen the foreign retailers and weaken the Indian market.

Thus it comes to the conclusion that the foreign retailers are only using the Indian market for its consumers and not for its suppliers.