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“The silent conspiracy

India can still become an important FDI destination”

by S L Rao

Managers of the Indian Economy face the challenge of collapse of growth. There are four factors that are responsible: continuing inflation, fiscal deficit, declining investment and a record current account deficit. Poor growth is related to poor investment. Investment is sluggish. High interest rates and the declining foreign exchange value of the Rupee are two reasons. Cuts in expenditures, and subsidies and improved tax collection have reduced the deficit. But the unwillingness of government to slash social welfare expenditures, and improve administrative efficiencies remains. Ballooning social welfare expenditures, boosted by the looming annual Rs 60000 to 100000 lakh crores food security bill, remain as threats.

Land acquisition delays, slow environmental and forest clearances, absence of time bound bureaucratic clearances,

honest investigative practices, slow Court judgments, to name a few, have kept away investment.

The current account deficit is due to high crude oil, coal and gold imports. Nationalized coal mining has been inefficient and unable to dig the coal out as is possible. Exports are depressed due to the sluggish world economy and the scams that have affected major commodity exports like iron ore. The suspicions (now proven by Ranbaxy and Wockhardt) about falsification of trial results will affect pharmaceutical exports.

Rising foreign investment can restore the balance of payments and stimulate the economy. Rising domestic investment (both private and public) would be an economic stimulus. But domestic investment is actually going overseas. Foreign investment is not as confident about India as it was some years ago.

RBI categorizes foreign investment into direct and portfolio investments. Direct investment is in equity or debt and recently has been redefined to include foreigners holding above 10% in any venture. Portfolio investment is in debt, securities through the FII route, up to 10% of the securities traded in both primary and secondary capital markets including shares, debentures, warrants, and units of mutual funds, government securities and derivative instruments. Between 2000-01 and 2011-12, direct investment rose from $ 3270 million to $ 22006 million; and portfolio investment from $ 2590 million to $ 17171. Our dependence on the latter is high. They are volatile and inflows and outflows seesaw the stock market and Rupee exchange rates.

Comparing with China, India comes out poorly on consistent GDP growth, low inflation, current account surplus, superlative infrastructure and foreign direct investment. China has grown primarily because it was such an attractive destination for foreign direct investment. Low wages, productive labour, practically non-existent labour legislation, made it a great manufacturing destination. From mere assemblers China has moved over the years to becoming important manufacturers of basic industrial goods. It had no restrictions on technology imports or0 royalties. It is known that a significant amount of foreign investment was money belonging to Chinese residents sent illegally abroad and brought back as foreign investment. Another chunk was from overseas Chinese in Taiwan, Hong Kong, USA and elsewhere. But it also came from Japan, Korea, Europe and the USA. Most of the foreign investment was direct. In recent years as the stock markets developed in China investment has also come as portfolio investment. Return on FDI has been poor in China; copying is common and patent protection weak..

India has all of China's faults, not its strengths. We encourage round tripping of Indian funds by treating investments from countries like Mauritius to their tax laws (no capital gains tax). For years, technology imports were controlled, royalties low, bureaucratic approvals were many and time wasting.

Implicit policy was to encourage institutional portfolio investments. Foreign investment has been mainly as foreign institutional investment, external borrowings and NRI remittances. Foreign direct investment into building new factories has been poor for some years, and more into buying existing businesses, not adding fresh industrial capacities.

India needs massive foreign investment especially in infrastructure (roads, power, ports, railways, airports, etc). There is little coordination and agreement on matters concurrent to the central and state governments. There has yet been little foreign investment in all infrastructures, except the failed Enron and minor power projects. Complex bureaucratic procedures for many approvals, changing guidelines, multiple clearances, avoidable delays in land acquisitions, and other approvals, add to costs. Government does not compensate these losses.

The UPA government has promoted FDI in insurance, pension funds, multi-brand retail, etc. The conditions imposed, changing rules, and regulatory frameworks, create uncertainty. Tax issues and transfer pricing create uncertainty. Many prospective investors are wary of investing in India.

Foreign investment is still suspect, with many politicians and others. Decades of hostility to private investment, private profit, and foreign investment created a mindset. Society believes essential services (water, electricity, road transport, etc), must be free or cross-subsidized by suppliers. This have led to unbridled increases in deficits of state owned enterprises in infrastructure. Infrastructure investments must produce adequate returns for maintenance and further investments.

India has done much to stimulate foreign institutional investment into equities, debt, and other financial instruments. FII has been encouraged by politicians and bureaucrats as well as businessmen. It has helped black money from India to go out by *hawala* and return to be laundered in Indian stock markets. The money laundry not only whitewashes black. It rewards the money laundry. This arrangement enables Indians with illegal funds (black money), to send it out by *hawala*, bring it back for equity investment, and legally send it out again. Black has become white money. A genuine forensic investigation will perhaps show that much of the present FII to India is really Indian money coming back by these routes.

Another clever means of sending money out has been 'participatory notes', funds sent anonymously by banks

overseas for investment into India. In this case the overseas bank manages the investment and credits the owner without any information to the Indian government.

Genuine FII has in the last two years been hurt by the downturn in the European economies and the preference of investors for the safety of the dollar for investment. This is despite the tribulations of the US economy. There is innate confidence in the dollar as reserve currency and the innovative ability of the US economy.

We can become an important FDI destination and build a current account surplus, like China. For that to happen, we should remove all restrictions on foreign investment including into defence industries. There should be no compulsory cap or compulsion to have local investment participation. Clearances must be simplified. Taxation should be stable, clear, and consistent. For this the bureaucracy and individuals in it should be made responsible and accountable for time bound clearances. Land acquisition should be made easier even if it requires an ordinance in the absence of legislation. Present legislative changes will not help. Inflation should be cut and for this government deficits must come down. This requires a pruning of much misspending and theft of wasteful social welfare and other expenditures. So much of it is stolen or reaches people who are not among the defined poor for whom the scheme was designed. The Centre must provide incentives to state governments that create the environment that attracts foreign investment to their states.

These policies should have been introduced in our years of high growth, low inflation, low current account and fiscal

deficits. Today, government must as it is doing, get foreign money into our reserves by any means. But we should have a blueprint of what must be done when our situation allows it, to increase FDI significantly in foreign investment into India.

The biggest stumbling block is the unspoken conspiracy between politicians, bureaucrats and businessmen, to encourage portfolio investment through many avenues.

(1288)