Reforms & Manufacturing Sector (2017)

R. Nagaraj

Part 1 – Reforms and Global Integration

Lecture -1

Introduction

- Manufacturing has emerged as one of the high growth sectors in India. Prime Minister of India, Mr. Narendra Modi, had launched the 'Make in India' program to place India on the world map as a manufacturing hub and give global recognition to the Indian economy.
- India is expected to become the fifth largest manufacturing country in the world by the end of year 2020. Government aims to achieve 25 per cent GDP share and 100 million new jobs in the sector by 2022.
- Achieving these targets require a understanding of industrial achievements in term of periods of high and low growth , its structure and reason for prolonged stagnation.

Industrial achievements and relative performance

- Over a quarter century of market-oriented reforms (1991–2016), the manufacturing (or industrial) sector has grown annually between 7% and 8%
- The growth rate after the reforms is higher than in the preceding quarter century, but it is roughly the same as in the 1980s, when the early reforms were initiated.
- India's share in global merchandise trade has moved up from nearly 0.5% in 2000 to 1.5% by 2015, and the share of services exports rose from 1% to 3% during the same period.
- Industrial production has diversified with perceptible improvements in the quality and variety of goods produced with growing domestic competition. Yet, the manufacturing sector's share has stagnated at about 14%–15% of gross domestic product (GDP) after the reforms .

- Though India has avoided deindustrialization— defined as a decline in the manufacturing (industrial) sector's share in GDP, or share in workforce.
- It stares at a quarter century of stagnation, in contrast to many Asian economies that have moved up the technology ladder with a rising share of manufacturing in domestic output and global trade.
- However, over a longer period, Indian industry has regressed. The telling evidence of it is a comparison with China. Around 1950, both the large Asian giants were roughly at the same level of industrialization . By 2010, China became world's second largest manufacturing nation, and India ranked 10th, producing one-third or one-fourth of China's industrial output

Changing façade of reforms

- The reforms were initially underwritten by structural adjustment loans from the Bretton Woods institutions, conditional upon implementation of the policy changes (as against World Bank's predominant interest in project finance)
- It was built on the initial success in delicensing and import liberalization (that is, a switch from quotas to tariffs) in the 1980s.
- However, deepening of the reforms since the 1990s as part of the broader stabilization and structural adjustment programme, meant a clear departure from the state-led domestic-oriented, capital goods- focused, "heavy" industrialization strategy, towards a market-friendly regime, as advocated by most mainstream economists and development agencies, such as the World Bank (as evident in its official publication, The East Asian Miracle, 1993)

- Though initially centered on industry and trade, culminated in encompassing financial globalization in the last decade, when India got enmeshed in the global economic cycles of boom and bust.
- The public sector was rolled back even within the "conventional confines of utilities and infrastructure" by allowing private and foreign capital in these industries.

Jagdish Bhagwati characterization of pre-reform era policies

- Main elements of India's policy framework that stifled efficiency and growth until the 1970s, and somewhat less so during the 1980s are divided into three major groups:

(1) Extensive bureaucratic controls over production, investment and trade;

(2) Inward-looking trade and foreign investment policies;

(3) A substantial public sector, going well beyond the conventional confines of public utilities and infrastructure.

This gives the impression that reforms meant to drastically change industrial polices but in practice reforms were gradual in nature.

Increasing global integration and its fallouts for India

- India surely rode the boom during its "dream run" for five years from 2003 to 2008, to clock an unprecedented annual economic growth of about 9%, to be counted as among the world's fastest growing large economies .
- Perhaps, with booming services exports, India dreamt of skipping the industrialization stage to be counted as the world's back office, leveraging its large "educated" English-speaking workforce, and ignoring outsourcing services' narrow employment base domestically, and even the slender market segment it was tied to in the financial services sector in the United States.
- If China came to be known as the world's factory, India was reckoned, albeit briefly, as its back office. After the global financial crisis, as with the rest of world, India's boom went bust, with industrial deceleration, rising import dependence, and growing short-term capital inflows financing the balance of payments deficit.

- We are now back to the drawing board, trying to configure how to reindustrialize, given India's persistent economic backwardness (with half of its workforce still engaged in low productive agriculture, and over two-thirds of the population still living in villages) with bleak export prospects, and fickle capital inflows financing its external deficit.

- It is in this context , this paper critically reviews industrial performance and policy after the reforms in 1991, and seeks to address the question of how to get over the stagnation

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Part 2 - Industrial Trends

Lecture -2

- Over the entire period of reforms (1991– 2014), the manufacturing sector grew at an annual trend growth rate of 7.7% or 7.2% as per the Annual Survey of Industries (ASI) and Index of Industrial Production (IIP), respectively .
- Evidently, the ASI recorded much wider yearly fluctuations than the IIP, which would show wide differences in the growth rates over shorter periods.

Industrial trends

- It is evident that the 25-year period can be subdivided into three distinct phases: 1992–96, 1997–2003 and 2003–14 .
- The first phase represents the initial euphoria of reforms, with booming output and investment in the anticipation of a virtuous cycle of faster growth and exports.
- However, with the expectations of a boost in demand not being realized, industrial growth decelerated. It coincided with the Asian financial crisis, bust of the dot-com bubble, and freezing of credit markets in the US in the early 2000s.

- The period from 2003 to 2014 represents, as mentioned earlier, the recent debt-led cycle of boom and bust, perhaps best illustrated by the trends in India's and global exports .
- After the global financial crash in 2008–09, fiscal and monetary stimulus domestically and capital inflows on account of quantitative easing (QE) in the advanced economies sustained economic growth until 2011–12 (as also in many emerging market economies), giving rise to a short-lived euphoria of emerging market economies (EMEs) getting "delinked" from the advanced economies

- The industrial growth scenario after 2014 remains hazy on account of unreliable data. While the IIP shows marginal improvement, the new series of the National Accounts Statistics (NAS) reports a distinct upturn—a widely contested statistic.
- The turnaround in industrial and domestic output growth rates are not supported by the trends in (i) credit growth and (ii) capacity utilization in industry.

Performance during boom and bust

- From 1991 to 2003, industrial performance was not particularly impressive. After the initial boom until 1996, there was a nine-year period of deceleration, when the output growth was buffeted by many shocks, such as the Asian financial crisis.
- However, the following cycle of boom and bust (2003–14) was significant in many respects. Five years of India's dream run (2003–04 to 2007–08) were surely led by outsourcing services exports, but manufacturing growth matched the boom with a 10% annual growth rate.
- This was made possible by a steep rise in domestic savings, investment, and capital inflows, boosting the capital formation rate to close to 40% of GDP at the peak of the boom in 2008 . The growth rate recovered after the financial crisis in 2008–09, but at a slower rate of 7.3% per year in the following four years until 2011–12, and decelerated rapidly there after.

- If we look at the average of annual growth rates from 2004–05 to 2013–14, as per the Index of industrial production , for use-based industrial categories.
- In this period, consumer durable goods and capital goods (with each weighing about 8% in the IIP) grew close to 10% per year, while consumer non-durable goods (with a weight of 21%) grew the slowest at 4.2% per year.
- This was also the time when foreign firms and brand names came to dominate many markets, especially consumer durables and capital goods.

- The import to domestic output ratio went up quite sharply in most industries . However, if indirect imports are included, the ratio would go up further.
- In the 2000s, two significant policies were initiated for industrialization, namely, special economic zones (SEZs) and unfreezing of the land market for private industrial and infrastructure investment.
- Until then, export processing zones were set up by the public sector, and land acquisition for infrastructure was their exclusive domain. When these activities were thrown open to private and foreign capital, the results were dramatic.

- The land market quickly got commercialized, with easy access to domestic and international capital, and with property development acquiring primacy over industrial use of land.
- In practice, these policies—meant for promoting industrial exports and infrastructure—quickly became a means of acquiring scarce land, often with state support, from gullible farmers who sold their land cheap or were evicted with the state's connivance, giving rise to the term, "predatory growth" (Bhaduri 2008).
- This resulted in widespread political and social agitations against such policies, contributing little by way of industrial output.

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Part 3 –Reimaging the Role of State

Lecture 3

Persistent questions

- How does one understand the foregoing account of industrial performance?
- Many would agree that industry underperformed, but the reasons proffered for it could vary considerably.
- By no stretch of imagination could state policy constrain industrial decision-making any longer. With India's tariff getting reduced, and with numerous bilateral trade and investment treaties, India's openness became comparable to its Asian peers.
- Crucially, if the much derided permit–license raj had held up industrial growth during the planning era, then why did industrial output and exports not zoom after the reforms?

Three Competing explanations

1. Reform Agenda is Incomplete.

2. Labour market is full of rigidity.

3. Ease of doing business need to be improved.

- Before reaching any conclusion, we need to analysis each of these explanations carefully.

More reforms needed

- Protagonists of reforms, however, would contend that the reforms have not gone far enough or the agenda remains incomplete—with restrictions remaining on foreign direct investment (FDI) (especially in retail trade), labour market regulation (in the ability to hire and fi re at will), full convertibility of capital, etc. These arguments seem questionable.
- There is no clear theoretically valid and empirically sound association bet ween pro-market reforms and growth (Rodrik 2011).
- There is perhaps room for critically examining what has been the outcome of the liberalization carried out thus far

- What has India's open-door policy for FDI led to?
- In the last decade, the most significant variety of FDI inflow has been private equity (PE), venture capital (VC), and hedge funds (HF), which are, by definition, loosely regulated alternative investment funds that are part of shadow banking.
- They are not even considered as FDI by the United Nations Conference on Trade and Development definition since they are not for the long-term. Quantitatively, the most important of these sources is PE funds, which, by definition, acquire existing assets and sell these after three–fi ve years in the stock market after restructuring.
- These are hardly the kind of foreign capital that India needs for getting technology and acquiring industrial capability of domestic consumption using foreign debt, not productive investment.

Labour Market Rigidity hypothesis

- The labour market rigidity hypothesis is seriously contested; careful reviews of the literature find little support for the widely held proposition.
- labour market rigidity argument holds little water now can be gauged by the recent news report that Larsen & Toubro, India's largest machinery and construction firm reportedly laid off 14,000 workers (11.2% of its workforce of 1.22 lakh workers) during July–September 2016 (Prasad 2016).
- It amply demonstrates that the "hire and fire" policy effectively rules the organised labour market today. Arguably, the retrenched workers are temporary or contract workers who are not protected by labour laws, which are the bone of contention.
- But, the fact that such a large enterprise employs non-permanent workers in such large numbers only goes to show how the seemingly rigid laws do not apply to a growing segment of organized workers.

Improving "Ease of dong Business"

- Currently, policymakers are using the World Bank's "Ease of Doing Business" (EDB) as a measure of hurdles faced by entrepreneurs, and are busy trying to improve India's global ranking to attract more foreign investment.
- This dubious measure, both conceptually and empirically, hardly explains the foreign investment inflows in developing countries.
- However, do improvements in rankings generate greater foreign direct investment inflows?
- Studies (Jayasuriya 2011) show this relationship is significant for the average country. However, when the sample is restricted to developing countries, the results suggest an improved ranking has, on average, an insignificant (albeit positive) influence on foreign direct investment inflows.

- Additionally, on average, countries that undertake large-scale reforms relative to other countries do not necessarily attract greater foreign direct investment inflows.
- This analysis may have important ramifications for developing country governments wanting to improve their Doing Business Rankings in the hope of attracting foreign direct investment inflows.

Long term constraints on industrial growth

- The answer perhaps lies with the structuralist economic arguments and the long-term constraints, such as less than satisfactory or poor agriculture performance after the reforms .
- Moreover, despite gradual improvements, land productivity in agriculture continues to be a modest fraction of the global average.
- Further, lack of adequate public infrastructure investment (as capacity creation for power generation by proxy) seems to be holding back industrial growth.

Need to reimagine the role of state

- While the foregoing arguments for removing the structural constraints on industrial growth still hold, it is perhaps an opportune moment to revisit the role of state support for industrialization. Admittedly, state intervention during the planning era (1950–80) had many shortcomings.
- Yet, perhaps, the rush to open up markets after 1991 (under stressed macroeconomic conditions) seems to have hurt long-term industrial and trade prospects. So, there seems to be a need to rebalance the equation between the state and the market keeping in view the strategic considerations.

Reorienting industrial & investment policies

- Three aspects of industrial and investment policies that seem to need careful attention are:

(i) long-term finance

(ii) domestic research and development (R&D) efforts

(iii) bilateral investment and trade treaties

India seems to have a disadvantage vis-à-vis its trading partners, especially with respect to China in all these policies.

Long term finance

- As part of financial liberalization, India turned its development financial institutions (DFIs)—such as IDBI (the Industrial Development Bank of India) and ICICI (Industrial Credit and Investment Corporation of India)—into commercial banks, resulting in shortening of loan maturity, thus constraining capital-intensive manufacturing and infrastructure financing.
- The domestic debt market was expected to fill the vacuum, and that has not happened (as in most industrializing countries). In response, large firms were allowed to borrow internationally even for investments in the non-traded goods sector, leading to currency and maturity mismatches, thus raising potential financial instability.
- China, which is still not officially granted the status of a market economy, is known to use cheap credit (including trade credit) as an instrument for penetrating international markets, especially in project exports.

- Commercial sources often suggest that Indian firms are perhaps unable to match the Chinese firms' commercial terms, despite producing goods of comparable quality and variety. This is not new.
- Historically, finance is widely used as an instrument of trade policy. If the above speculation is correct, then there is a case for revisiting national development or investment banks for supply of long-term, low-cost credit for industrial capital formation.
- Such a case has acquired greater urgency in the context of the continuation of the global financial crisis, and the need for public investment to pull the depressed economies out of the present crisis.

Domestic R & D

- Another setback after the industrial reforms has been the decline in domestic industrial R&D. The licenses to import technology and capital in the pre-reform era were conditional upon setting up domestic R&D centers (sweetened with fiscal concessions) to promote indigenous know how.
- After the reforms, firms no longer needed to make such efforts, and foreign firms had no reason to invest in R&D in India that could potentially compete with their parent fi rms' global interests.
- The net result: stagnation in R&D efforts, best illustrated again with a Chinese comparison. In 1996, both China and India spent the same share of their GDP on R&D, at 0.6%.

- However, by 2011, the ratio for China had tripled to 1.8% of GDP, whereas for India the ratio had marginally moved up to 0.8%. Interestingly, despite its liberal FDI policy, China did not take its eyes off the strategic significance of R&D, whereas India perhaps lost its focus in the free market rhetoric (Mani 2016).

Bilateral relations

- At the height of the financial opening-up in the last decade, India signed a large number of bilateral free trade and investment agreements, whose outcome for industry appears to be questionable (Dhar et al 2012- from your first unit reading).
- In particular, the treaty with Thailand, a large base of the Japanese automotive industry, seems to have hurt Indian automotive firms', enabling the duty-free entry of goods. If the observation is correct, then there is perhaps merit in reviewing such agreements.
- This is not to argue for unconditional protectionism or unalloyed faith in the state's capacity to promote industrialization, but to seek for a more reasoned, rule-based support for industry.
- This should not be seen as a plea for putting the clock back; such a view would be ahistorical. What is needed, perhaps, is the redefining and reconfiguring of the boundaries of state and market in view of the changed ground realities, comparative experiences, and the renewed analytical arguments for suitable state intervention

FDI & FPI flows : Indian Experience

Nagesh Kumar

Part 1- Evolution of Policy Regime

Lecture -4

Introduction

- Capital flows have emerged as key channels of global economic integration all across the world over the past tow decades.
- While FDI flows have been undertaken for a long time by multinational corporations in the course of their overseas expansion , foreign portfolio investments (FPIs) representing equity and debt flows unaccompanied by management controls have become highly visible and often dominant components of foreign capital flows in recent years with rise of foreign institutional investors (FIIs) and sovereign wealth funds on the horizon that seek to make quick returns though short term speculative activities abroad.

- FDI flows represent longer term investments made abroad brining together with capital and entrepreneurship , technology and managerial know how and sometimes even market access, hence are seen by developing countries as catalysts of development.
- FPIs, in contrast tend to have limited potential of contributing development , given their short term speculative nature. Their distribution across countries is highly uneven as they target only the fastest growing economies and those with deep capital markets to benefit from their dynamism.
- Often they seem to bring volatility in financial and exchange rate markets thereby leading many countries to moderate their volatility through restrictions on capital flows.

- Recent years have also seen the rise of FDI and FPI flows in India. This can be partly attributed to substantial liberalization of the policy regime since 1991 and with her economy embarking on robust growth trajectory in the new millennium.
- India also begun to attract increasing attention of MNEs as well as FIIs as destination for investments . Indian enterprises have also begun to use outward FDI as a strategic tool for strengthened their international competitiveness.
- Against that background , this reading looks at Indian experience in attracting FDI & FPI and reviews the recent trends, patterns and prospects for these flows and developmental impact.

Evolution of policy regime: Different phases

Soon after independence

- India embarked on a strategy of import substituting industrialization in the framework of development planning with a focus on encouraging and improving the local capability in heavy industries including the machinery manufacturing sector.
- As the domestic base of created assets viz., technology, skills, entrepreneurship was quite limited , the attitude towards FDI was increasingly receptive. FDI was sought on mutually advantageous terms , tough the majority local ownership was preferred.

Late 1960s

- The government adopted a more restrictive attitude towards FDO as the local base of machinery manufacturing capability and local entrepreneurship developed and as the outflow on account of remittances of dividends, profits , royalties, and technical fees, etc., abroad on account of servicing of FDI and technology imports grew sharply.
- Restrictions were put on proposals of FDIs unaccompanied by technology transfer and those seeking more than 40 % foreign ownership.

From 1973 onwards

- Further activities of foreign companies were restricted to a select group of core or high priority industries. Foreign exchange regulation act of 1973 required all foreign companies operating in India to register under Indian corporate legislation with up to 40 % foreign equity.
- Exceptions from the general limit of 40 % were made only for companies operating on high priority or high technology sectors , tea plantations or those producing predominantly for exports.

In the 1980s

- Attitude toward FDP began to change as pert of strategy of modernisation of industry with liberalised imports of capital goods and technology , exposing the Indian industry to foreign competition , and assigning a greater role to MNEs in the promotion of manufactured exports.
- The policy changes adopted in the 1980s covered liberalization of industrial licensing rules, a host of incentives, and exemption from foreign equity restrictions under FERA to 100 % export oriented units and a degree of flexibility concerning foreign ownership.

1990s

- India changed its tracks and embarked on a broader process of reforms designed to increase integration with global economy. Among the reform measures implemented included a departure from the restrictive policy towards FDI , a much more liberal trade policy besides reforms of capital market and exchange controls.
- The New industrial policy marked a major departure with respect to FDI policy with abolition of industrial licensing system except where it is required for strategic grounds, creation of a system of automatic clearance of FDI proposals fulfilling conditions laid down such as the ownership levels of 50%, 51%, 74% and 100% foreign equity and opening up of new sectors such as mining, banking , insurance, telecommunications , construction and management of ports, harbours, roads and highways, airlines and defence equipment, to foreign owned companies subject to sectoral caps.

- Foreign ownership up to 100% is permitted in most manufacturing sectors , in some sectors even on automatic basis except for defence equipment where it is limited to 26% and for items reserved for production by small scale industries where it is limited to 24%.

2000 onwards

- Dividend balancing and the related export obligations conditions on foreign investor, which applied to 22 consumer goods industries, were withdrawn in 2000. In September 2012, India allowed FDI in multiband retail and in civil aviation. Sectoral caps were revised upwards in July 2014 in some sectors like telecom to 100%, in insurance to 49% and in defence equipment beyond 26% on a case by case basis.
- In September 1992, Indian government announced guidelines for investments by FIIs in the Indian capital markets. FIIs were now welcome to invest in all types of securities traded on the primary and secondary market with full repatriation benefits and without restrictions on either volume of trading or lock in period.

- This liberalization has led to considerable portfolio inflows making the country one of the most exposed to portfolio inflows. In June 2013, FII investments were reclassified as FPI which is subject to their holding in company within 10% of its equity. Any holding beyond 10 % will qualify as FDI.
- Policy governing outward FDI has also been liberalized since 1991.with the build up of foreign exchange reserves , the limits for outward investments have been gradually relaxed and Indian enterprises are now permitted to invest abroad up to 100% of their net worth on automatic basis.
- So far we have entered into 88 Double taxation avoiding treaties, & bilateral investment promotion agreement with over 82 countries.

FDI & FPI flows : Indian Experience

Nagesh Kumar

Part 2 – FDI Prospects & Its Quality

Lecture – 5

Prospects

- Empirical studies of determinants of FDI inflows have found an important role of market size, extent of urbanization, quality of infrastructure, geographical and cultural proximity with major sources of capital, and policy factors, e.g., tax rate, investment incentives , performance requirements , among other factors.
- In light of these findings , while India large population base may be an advantage, low income levels , low levels of urbanization and relatively poor quality of infrastructure are disadvantages' furthermore, India also doesn't have benefit of geographical and cultural proximity with major sources of FDI such as the US, Europe or Japan.
- However , over time relative attractiveness of the country is improving with rapid growth and other aspect of macroeconomic performance.

- A recent intertemporal study for India has found a broad correspondence between industrial growth rates in a year and FDI inflows received in following year. Apparently good industrial performance tends to crowd in FDI inflows as well.
- The recent rise in FDI inflows since 2006 reflects improving investment climate in India with the acceleration of growth rate since 2003, the rise of sizeable middle class with purchasing power, and with recognition of India's comparative advantage in knowledge based industries.
- This is not only evident from rising magnitudes of FDI inflows but also from investor surreys conducted by global consultancy organisations.

- Recent reforms adopted by country to allow FDI in multi-brand retail and civil aviation and large infrastructure projects such as Delhi Mumbai Industrial Corridor are also likely to help in realising its potential for FDI inflows.
- This is in sharp contrast to World Bank's studies on ease of doing business based on perception surveys that tend to put India at a very poor rank of 132 (this reading was written in 2014).
- It is clear therefore that foreign investors get attracted to a country by the potential of benefiting from its dynamism and are willing to put up with hardships rather than going to countries with easier business conditions but poorer prospects of making profits.

Quality of FDI inflows

There can be several indicators of quality of FDI inflows . We will discuss four indicators as follow :

1. Sectoral composition
2. Impact on domestic investment & growth
3. Share in exports
4. Technology diffusion and R&D investments

Sectoral Composition

- In terms of sectoral composition of FDI inflows , there is a shift since 1991 in India's case. Earlier the bulk of FDI inflows used to be directed to manufacturing especially the high technology industries through a selective policy. After the liberalization, a substantial proportion of FDI inflows has been directed to services.
- Manufacturing has accounted for only about 40% of inflows in the post 1991 period with services accounting for about 35% share. Among manufacturing subsectors, FDI stock in the post 1991 period is also more evenly distributed between food and beverages. transport equipment , metals products and miscellaneous manufacturing.
- This stands in contrast to situation prior to 1990 when there was a very heavy concentration in relatively technology intensive sectors viz., machinery, chemicals, electricals, and transport equipment.

- In china , on the other hand bulk of FDI inflows have been directed by government policy to manufacturing and very little has gone to services.
- Of the FDI in manufacturing , 11% has gone to electronics and telecommunications equipment helping it emerge as the leading producer and exporter of these products. Thus FDI inflows in china have been directed to assist in industrial development of industry that has made china a global factory , generating billions of dollars of output and exports and millions of jobs.

Growth and Domestic Investment

- FDI inflows could contribute to growth rate of the host economy by augmenting capital stock as well as with infusion of new technology. However, high growth rates may also attract more FD inflows by enhancing investment climate in the country.
- Therefore , the FDI growth relationship is subject to causality bias given the possibility of two way relationship.
- Recent study (Pradhan 2005) has examined the direction of causation between FDI & growth for a sample of 107 countries for the 1980s and 1990s period. In case of India, study finds relationship to be neutral as direction of causation as not pronounced.

- FDI can also crowd out or substitute domestic investment from the product or capital markets with the market power of their well known brand names and may thus be immiserating.
- It is therefore important to examine impact of FDI on domestic investment to asses its impact on growth and welfare in host economy.
- An earlier study to examine the effect on domestic investment in a dynamic setting, however, did not find a statistically significant effect of FDI on domestic investment in the case of India.
- It therefore appears that FDI inflows received by India have been of mixed type combining some inflows crowding in domestic investments while other crowding them out, with no predominant pattern emerging in the case of India.

- Therefore, the quality of FDI in India in respect to its impact on growth and on domestic investment is of mixed type and leaves scope for improvement.
- The empirical studies on the nature of relationship between FDI and domestic investments suggest that the effect of FDI on domestic investment depends on host government policies.
- Governments have extensively employed selective policies and imposed various performance requirements such as local content requirements to deepen the commitment of MNEs to the host economy.

- A case study of the auto industry where such a policy was followed shows that these policies (in combination with other performance requirements viz., foreign exchange neutrality) have succeeded in building an internationally competitive vertically integrated auto sector in the country.
- The Indian experience in this industry , therefore is in tune with experiences of Thailand, Brazil and Mexico (Moran 1998).

Export Orientation

- In this respect , China has had a considerable success in exploiting the potential of FDI for export oriented production. A very substantial 55% proportion of manufactured exports of China are undertaken by foreign invested enterprises, which account for as much as 80% of all technology intensive exports (UNCATD, 2005)
- Unlike the East Asian countries , India has not been able to exploit the potential of FDI for export oriented production. The bulk of FDI inflows in India are market seeking coming for tapping the domestic market with the share of foreign affiliates in exports around 10%. Therefore the quality of FDI in respect of export orientation is poorer compared to FDI received by East Asian countries.

Two observations in this context :

- First , recent studies of export performance are beginning to indicate a relatively superior performance of foreign enterprises in terms of export orientation compared to early studies suggesting a poorer performance of foreign companies. There fore , MNEs are gaining to exploit the potential of India as base for export oriented production.
- Second , a quantitative study analysing the determinants of the patterns of export orientation of MNE affiliates across 74 countries in seven branches of industry over three points of time has shown that in host countries with large domestic markets, the export obligations were effective for promoting export orientation of foreign affiliates to third countries.

- India has not imposed export obligations on MNE affiliates except for those entering the products reserved for SMEs. However , indirect obligations in the form of dividend balancing have been imposed for enterprises producing primarily consumer goods (phased out in 2000).
- Sometimes a condition of foreign exchange neutrality has been imposed where enterprises required to earn foreign exchange enough to even cover the outgo on account of imports.
- Therefore , these regulations have acted as indirect export obligations prompting foreign enterprises to export to earn the foreign exchange required by them.
- Evidence that is available suggests that such regulations have prompted foreign enterprises to undertake exports. For instance , Indian experience with auto industry goes in tune with this.

R & D and Technology Diffusion

- Within the country , foreign firms appear to be spending more on R & D activity in India than local firms , although gap between their R &D intensity has tended to narrow down.
- A study analysing the R & D activity of Indian manufacturing enterprises in the context of liberalization has found that after controlling for extraneous factors, MNE affiliates reveal a lower R &D intensity compared to local firms, presumably on account of their captive access to the laboratories of their parents and associated companies.
- The study also observed differences in the nature or motivation of R&D activity of foreign and local firms. Local firms seem to be directing their R&D activity towards absorption of imported knowledge and to provide a backup to their outward expansion. MNE affiliates on the other hand, focus on customization of their parents' technology for the local market (Kumar & Agarwal, 2005)

- An important issue is diffusion and absorption of technology borught by foreign firms in the host countries. Some governments have imposed technology transfer requirements on foreign enterprises , e.g., Malaysia.
- However such performance requirements don't appear to have been very successful in achieving their objectives. Instead , other performance requirements such as local content requirements or domestic equity requirements may be more effective in transfer of technology.
- Some have expressed the view that domestic equity requirements may adversely affect the extent or quality of technology transfer . However it has been shown that MNEs may not transfer key technologies even tot heir wholly owned subsidiaries abroad fearing the risk of dissipation or diffusion through mobility of employees.
- Also , Indian experience with two wheeler industry shows that domestic equity requirements can really help in technology diffusion.

FDI & FPI flows : Indian Experience

Nagesh Kumar

Part 3 – FPI Impact & Policy lessons

Lecture -6

FPI inflows and their impact

- Large magnitudes of portfolio investments in the form of short term equity investments by FII have flowed in as the Indian economy gathered momentum and capital markets started giving attractive returns. The annual net inflows , however, are highly volatile.
- FII inflows have become primary determinants of the movements in the stock exchange indices and the exchange rate of the rupee. As there are sharp movements in these inflows linked to global developments, they become channels of transmission of instability to the country's financial system.

- As a result , rupee has been on a roller coaster ride: from Rs. 44 per dollar in January 2007 to Rs. 39 in January 2008 to increase again to Rs. 49 per dollar in January 2009 to Rs. 44 in October 2010. The rupee fluctuated around Rs. 54 in 2012 and early 2013 and after May 2013 depreciated sharply to cross Rs.60 to a dollar , as there was outflow of FIIs in anticipation of roll back of quantitative easing policy by federal reserve in the US and as concerns about India's rising current account deficit mounted.

- Presently it is around 76 Rs. Per dollar, due to coronavirus pandemic , investors are selling their Indian holdings causing rupee to depreciate further which lead RBI to announce that it will conduct $ 2 billion currency swaps over six month to control falling rupee.

- Besides volatility , FII inflows have a very high servicing burden. Among foreign resources such as FDI , foreign borrowings, non-resident Indian deposits , American Depository receipts , Global depository receipts, FII investment are most expensive in terms of servicing burden (Kumar, 2011)
- This is because they come to chase primarily good returns at the stock markets and exchange rate speculation.
- In 2007-08, Indian stock markets were giving around 44% return which means for every dollar India received in FII flows, it become liable to pay $ 1.44 in one year. As they are stock price makers rather than takers, they manage to exit safely before major crashes of markets thereby precipitating the declines.

- In view of their high cost and other deleterious effects such as volatility , a number of emerging economies such as Brazil, South Korea and Indonesia have recently imposed capital controls to moderate their volatility.
- Unprecedent injection of liquidity by governments in developed countries in the wake of global financial crises is likely to find its way to emerging economies of Asia like India to take advantage of higher return.
- One may argue that FII inflows help a country to build foreign exchange reserves but it is also true that it also enhances the need to have large foreign exchange reserves due to their highly volatile nature.

FDI Outflows

- Like FDI inflows the major turnaround in their outflows came in 2006 when outflows more than quadrupled in one year to $ 14 billion and peaked to nearly $ 20 billion in 2007 before declining to around $ 15 billion in subsequent years in the wake of global financial crises.
- The past years have seen several multibillion dollar acquisitions of western firms by Indian companies including Tata Steel –Corrus, Tata Motors-Jaguar/Land Rover, Handalco-Novelis, among others.
- During 2012 and 2013, outward FDI flows declined dramatically as Indian companies struggled with slowdown of Indian economy.

- A recent analysis of India's outward FDI flows has shown hat among the emerging markets, scale of India's outward FDI was quite significant (Kumar, 2008). The emergence of Indian enterprises on the global scene is striking considering their origin in a lower middle income country.
- Considering that nearly all Indian enterprise undertaking outward investments had their origins in import substitution based industrialization strategies and the selective FDI policy regime, it would appear that the policy of infant industry protection with supportive institutional framework can assist in enterprise development by giving them access to domestic market to grow and build capabilities.

- However the protection need to be phased out once the capabilities are built up to expose the enterprise to international competition and sharpen their competitiveness.
- In fact, the reforms of 1991 have sparked of a considerable restructuring of Indian industry which emerged from it leaner, more efficient and competitive. The exposure also gave Indian firms global ambitions and also the confidence to pursue them. In some ways , Indian experience follows in the Japanese and Korean tradition of enterprise development policies and may have lessons for other developing countries.

Policy lessons

First , liberalization of FDI policy may be necessary but not sufficient for expanding FDI inflows . The overall macroeconomic performance continues to exercise a major influence on the magnitude of FDI inflows by acting as a signalling device for foreign investors about the growth prospects for the potential host economy.

Studies have shown that policies that facilitate domestic investments also pull in FDI inflows. While investment incentives may not be efficient, active promotion of FDI by developing certain viable projects and getting key MNEs interested in them could be useful in attracting investments in desirable directions.

- Second , intervention may be required to maximize gains in diffusion of knowledge brought in by foreign enterprises. An important channel of diffusion of knowledge brought in by MNEs in the host economy is vertical inter-firm linkages with domestic enterprises. Many governments in developed as well as developing countries have imposed local content requirements on MNEs to intensify generation of local linkages and transfer of technology.
- Host governments could also consider employing proactive measures that encourage foreign and local firms to deepen their local content as number of countries, e.g., Singapore, Taiwan, Korea and Ireland, have done so successfully (Battat et al., 1996)
- Knowledge diffusion could also eb accomplished by creating subnational or sub regional clusters of inter-related activities which facilitates the spill overs of knowledge through informal and social contacts among the employees besides traditional buyer-seller links.

- Last , rising CAP (current account deficit) poses an important challenge for policy makers and need urgent attention. With widening merchandise trade deficits driving this trend, immediate attention needs to be paid to reviving export growth and exploiting the opportunities for import substitution.
- In a situation of slowdown of the global economy as at present, a major expansion of exports can be challenging given an environment of excess capacities throughout the Asia-Pacific region, the growing threat of protectionism and the temptation of dumping by those with deep pocket's.
- Attention should be paid to very large and fast growing imports of electronics, non electrical machinery and defence equipment, among others that provide opportunities for strategic import substitution.

FDI & FPI flows : Indian Experience

Nagesh Kumar

Part 1- Evolution of Policy Regime

Introduction

- Capital flows have emerged as key channels of global economic integration all across the world over the past tow decades.
- While FDI flows have been undertaken for a long time by multinational corporations in the course of their overseas expansion , foreign portfolio investments (FPIs) representing equity and debt flows unaccompanied by management controls have become highly visible and often dominant components of foreign capital flows in recent years with rise of foreign institutional investors (FIIs) and sovereign wealth funds on the horizon that seek to make quick returns though short term speculative activities abroad.

- FDI flows represent longer term investments made abroad brining together with capital and entrepreneurship , technology and managerial know how and sometimes even market access, hence are seen by developing countries as catalysts of development.
- FPIs, in contrast tend to have limited potential of contributing development , given their short term speculative nature. Their distribution across countries is highly uneven as they target only the fastest growing economies and those with deep capital markets to benefit from their dynamism.
- Often they seem to bring volatility in financial and exchange rate markets thereby leading many countries to moderate their volatility through restrictions on capital flows.

- Recent years have also seen the rise of FDI and FPI flows in India. This can be partly attributed to substantial liberalization of the policy regime since 1991 and with her economy embarking on robust growth trajectory in the new millennium.
- India also begun to attract increasing attention of MNEs as well as FIIs as destination for investments . Indian enterprises have also begun to use outward FDI as a strategic tool for strengthened their international competitiveness.
- Against that background , this reading looks at Indian experience in attracting FDI & FPI and reviews the recent trends, patterns and prospects for these flows and developmental impact.

Evolution of policy regime: Different phases

Soon after independence

- India embarked on a strategy of import substituting industrialization in the framework of development planning with a focus on encouraging and improving the local capability in heavy industries including the machinery manufacturing sector.
- As the domestic base of created assets viz., technology, skills, entrepreneurship was quite limited , the attitude towards FDI was increasingly receptive. FDI was sought on mutually advantageous terms , tough the majority local ownership was preferred.

Late 1960s

- The government adopted a more restrictive attitude towards FDO as the local base of machinery manufacturing capability and local entrepreneurship developed and as the outflow on account of remittances of dividends, profits , royalties, and technical fees, etc., abroad on account of servicing of FDI and technology imports grew sharply.
- Restrictions were put on proposals of FDIs unaccompanied by technology transfer and those seeking more than 40 % foreign ownership.

From 1973 onwards

- Further activities of foreign companies were restricted to a select group of core or high priority industries. Foreign exchange regulation act of 1973 required all foreign companies operating in India to register under Indian corporate legislation with up to 40 % foreign equity.
- Exceptions from the general limit of 40 % were made only for companies operating on high priority or high technology sectors , tea plantations or those producing predominantly for exports.

In the 1980s

- Attitude toward FDP began to change as pert of strategy of modernisation of industry with liberalised imports of capital goods and technology , exposing the Indian industry to foreign competition , and assigning a greater role to MNEs in the promotion of manufactured exports.
- The policy changes adopted in the 1980s covered liberalization of industrial licensing rules, a host of incentives, and exemption from foreign equity restrictions under FERA to 100 % export oriented units and a degree of flexibility concerning foreign ownership.

1990s

- India changed its tracks and embarked on a broader process of reforms designed to increase integration with global economy. Among the reform measures implemented included a departure from the restrictive policy towards FDI , a much more liberal trade policy besides reforms of capital market and exchange controls.
- The New industrial policy marked a major departure with respect to FDI policy with abolition of industrial licensing system except where it is required for strategic grounds, creation of a system of automatic clearance of FDI proposals fulfilling conditions laid down such as the ownership levels of 50%, 51%, 74% and 100% foreign equity and opening up of new sectors such as mining, banking , insurance, telecommunications , construction and management of ports, harbours, roads and highways, airlines and defence equipment, to foreign owned companies subject to sectoral caps.

- Foreign ownership up to 100% is permitted in most manufacturing sectors , in some sectors even on automatic basis except for defence equipment where it is limited to 26% and for items reserved for production by small scale industries where it is limited to 24%.

2000 onwards

- Dividend balancing and the related export obligations conditions on foreign investor, which applied to 22 consumer goods industries, were withdrawn in 2000. In September 2012, India allowed FDI in multiband retail and in civil aviation. Sectoral caps were revised upwards in July 2014 in some sectors like telecom to 100%, in insurance to 49% and in defence equipment beyond 26% on a case by case basis.
- In September 1992, Indian government announced guidelines for investments by FIIs in the Indian capital markets. FIIs were now welcome to invest in all types of securities traded on the primary and secondary market with full repatriation benefits and without restrictions on either volume of trading or lock in period.

- This liberalization has led to considerable portfolio inflows making the country one of the most exposed to portfolio inflows. In June 2013, FII investments were reclassified as FPI which is subject to their holding in company within 10% of its equity. Any holding beyond 10 % will qualify as FDI.
- Policy governing outward FDI has also been liberalized since 1991.with the build up of foreign exchange reserves , the limits for outward investments have been gradually relaxed and Indian enterprises are now permitted to invest abroad up to 100% of their net worth on automatic basis.
- So far we have entered into 88 Double taxation avoiding treaties, & bilateral investment promotion agreement with over 82 countries.

FDI & FPI flows : Indian Experience

Nagesh Kumar

Part 3 – FPI Impact & Policy lessons

FPI inflows and their impact

- Large magnitudes of portfolio investments in the form of short term equity investments by FII have flowed in as the Indian economy gathered momentum and capital markets started giving attractive returns. The annual net inflows , however, are highly volatile.
- FII inflows have become primary determinants of the movements in the stock exchange indices and the exchange rate of the rupee. As there are sharp movements in these inflows linked to global developments, they become channels of transmission of instability to the country's financial system.

- As a result , rupee has been on a roller coaster ride: from Rs. 44 per dollar in January 2007 to Rs. 39 in January 2008 to increase again to Rs. 49 per dollar in January 2009 to Rs. 44 in October 2010. The rupee fluctuated around Rs. 54 in 2012 and early 2013 and after May 2013 depreciated sharply to cross Rs.60 to a dollar , as there was outflow of FIIs in anticipation of roll back of quantitative easing policy by federal reserve in the US and as concerns about India's rising current account deficit mounted.

- Presently it is around 76 Rs. Per dollar, due to coronavirus pandemic , investors are selling their Indian holdings causing rupee to depreciate further which lead RBI to announce that it will conduct $ 2 billion currency swaps over six month to control falling rupee.

- Besides volatility , FII inflows have a very high servicing burden. Among foreign resources such as FDI , foreign borrowings, non-resident Indian deposits , American Depository receipts , Global depository receipts, FII investment are most expensive in terms of servicing burden (Kumar, 2011)
- This is because they come to chase primarily good returns at the stock markets and exchange rate speculation.
- In 2007-08, Indian stock markets were giving around 44% return which means for every dollar India received in FII flows, it become liable to pay $ 1.44 in one year. As they are stock price makers rather than takers, they manage to exit safely before major crashes of markets thereby precipitating the declines.

- In view of their high cost and other deleterious effects such as volatility , a number of emerging economies such as Brazil, South Korea and Indonesia have recently imposed capital controls to moderate their volatility.
- Unprecedent injection of liquidity by governments in developed countries in the wake of global financial crises is likely to find its way to emerging economies of Asia like India to take advantage of higher return.
- One may argue that FII inflows help a country to build foreign exchange reserves but it is also true that it also enhances the need to have large foreign exchange reserves due to their highly volatile nature.

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FDI & FPI flows : Indian Experience

Nagesh Kumar

Part 2 – FDI Prospects & Its Quality

Prospects

- Empirical studies of determinants of FDI inflows have found an important role of market size, extent of urbanization, quality of infrastructure, geographical and cultural proximity with major sources of capital, and policy factors, e.g., tax rate, investment incentives , performance requirements , among other factors.
- In light of these findings , while India large population base may be an advantage, low income levels , low levels of urbanization and relatively poor quality of infrastructure are disadvantages' furthermore, India also doesn't have benefit of geographical and cultural proximity with major sources of FDI such as the US, Europe or Japan.
- However , over time relative attractiveness of the country is improving with rapid growth and other aspect of macroeconomic performance.

- A recent intertemporal study for India has found a broad correspondence between industrial growth rates in a year and FDI inflows received in following year. Apparently good industrial performance tends to crowd in FDI inflows as well.
- The recent rise in FDI inflows since 2006 reflects improving investment climate in India with the acceleration of growth rate since 2003, the rise of sizeable middle class with purchasing power, and with recognition of India's comparative advantage in knowledge based industries.
- This is not only evident from rising magnitudes of FDI inflows but also from investor surreys conducted by global consultancy organisations.

- Recent reforms adopted by country to allow FDI in multi-brand retail and civil aviation and large infrastructure projects such as Delhi Mumbai Industrial Corridor are also likely to help in realising its potential for FDI inflows.
- This is in sharp contrast to World Bank's studies on ease of doing business based on perception surveys that tend to put India at a very poor rank of 132 (this reading was written in 2014).
- It is clear therefore that foreign investors get attracted to a country by the potential of benefiting from its dynamism and are willing to put up with hardships rather than going to countries with easier business conditions but poorer prospects of making profits.

Quality of FDI inflows

There can be several indicators of quality of FDI inflows . We will discuss four indicators as follow :

1. Sectoral composition
2. Impact on domestic investment & growth
3. Share in exports
4. Technology diffusion and R&D investments

Sectoral Composition

- In terms of sectoral composition of FDI inflows , there is a shift since 1991 in India's case. Earlier the bulk of FDI inflows used to be directed to manufacturing especially the high technology industries through a selective policy. After the liberalization, a substantial proportion of FDI inflows has been directed to services.
- Manufacturing has accounted for only about 40% of inflows in the post 1991 period with services accounting for about 35% share. Among manufacturing subsectors, FDI stock in the post 1991 period is also more evenly distributed between food and beverages. transport equipment , metals products and miscellaneous manufacturing.
- This stands in contrast to situation prior to 1990 when there was a very heavy concentration in relatively technology intensive sectors viz., machinery, chemicals, electricals, and transport equipment.

- In china , on the other hand bulk of FDI inflows have been directed by government policy to manufacturing and very little has gone to services.
- Of the FDI in manufacturing , 11% has gone to electronics and telecommunications equipment helping it emerge as the leading producer and exporter of these products. Thus FDI inflows in china have been directed to assist in industrial development of industry that has made china a global factory , generating billions of dollars of output and exports and millions of jobs.

Growth and Domestic Investment

- FDI inflows could contribute to growth rate of the host economy by augmenting capital stock as well as with infusion of new technology. However, high growth rates may also attract more FD inflows by enhancing investment climate in the country.
- Therefore , the FDI growth relationship is subject to causality bias given the possibility of two way relationship.
- Recent study (Pradhan 2005) has examined the direction of causation between FDI & growth for a sample of 107 countries for the 1980s and 1990s period. In case of India, study finds relationship to be neutral as direction of causation as not pronounced.

- FDI can also crowd out or substitute domestic investment from the product or capital markets with the market power of their well known brand names and may thus be immiserating.
- It is therefore important to examine impact of FDI on domestic investment to asses its impact on growth and welfare in host economy.
- An earlier study to examine the effect on domestic investment in a dynamic setting, however, did not find a statistically significant effect of FDI on domestic investment in the case of India.
- It therefore appears that FDI inflows received by India have been of mixed type combining some inflows crowding in domestic investments while other crowding them out, with no predominant pattern emerging in the case of India.

- Therefore, the quality of FDI in India in respect to its impact on growth and on domestic investment is of mixed type and leaves scope for improvement.
- The empirical studies on the nature of relationship between FDI and domestic investments suggest that the effect of FDI on domestic investment depends on host government policies.
- Governments have extensively employed selective policies and imposed various performance requirements such as local content requirements to deepen the commitment of MNEs to the host economy.

- A case study of the auto industry where such a policy was followed shows that these policies (in combination with other performance requirements viz., foreign exchange neutrality) have succeeded in building an internationally competitive vertically integrated auto sector in the country.
- The Indian experience in this industry , therefore is in tune with experiences of Thailand, Brazil and Mexico (Moran 1998).

Export Orientation

- In this respect , China has had a considerable success in exploiting the potential of FDI for export oriented production. A very substantial 55% proportion of manufactured exports of China are undertaken by foreign invested enterprises, which account for as much as 80% of all technology intensive exports (UNCATD, 2005)
- Unlike the East Asian countries , India has not been able to exploit the potential of FDI for export oriented production. The bulk of FDI inflows in India are market seeking coming for tapping the domestic market with the share of foreign affiliates in exports around 10%. Therefore the quality of FDI in respect of export orientation is poorer compared to FDI received by East Asian countries.

Two observations in this context :

- First , recent studies of export performance are beginning to indicate a relatively superior performance of foreign enterprises in terms of export orientation compared to early studies suggesting a poorer performance of foreign companies. There fore , MNEs are gaining to exploit the potential of India as base for export oriented production.
- Second , a quantitative study analysing the determinants of the patterns of export orientation of MNE affiliates across 74 countries in seven branches of industry over three points of time has shown that in host countries with large domestic markets, the export obligations were effective for promoting export orientation of foreign affiliates to third countries.

- India has not imposed export obligations on MNE affiliates except for those entering the products reserved for SMEs. However , indirect obligations in the form of dividend balancing have been imposed for enterprises producing primarily consumer goods (phased out in 2000).
- Sometimes a condition of foreign exchange neutrality has been imposed where enterprises required to earn foreign exchange enough to even cover the outgo on account of imports.
- Therefore , these regulations have acted as indirect export obligations prompting foreign enterprises to export to earn the foreign exchange required by them.
- Evidence that is available suggests that such regulations have prompted foreign enterprises to undertake exports. For instance , Indian experience with auto industry goes in tune with this.

R & D and Technology Diffusion

- Within the country , foreign firms appear to be spending more on R & D activity in India than local firms , although gap between their R &D intensity has tended to narrow down.
- A study analysing the R & D activity of Indian manufacturing enterprises in the context of liberalization has found that after controlling for extraneous factors, MNE affiliates reveal a lower R &D intensity compared to local firms, presumably on account of their captive access to the laboratories of their parents and associated companies.
- The study also observed differences in the nature or motivation of R&D activity of foreign and local firms. Local firms seem to be directing their R&D activity towards absorption of imported knowledge and to provide a backup to their outward expansion. MNE affiliates on the other hand, focus on customization of their parents' technology for the local market (Kumar & Agarwal, 2005)

- An important issue is diffusion and absorption of technology borught by foreign firms in the host countries. Some governments have imposed technology transfer requirements on foreign enterprises , e.g., Malaysia.
- However such performance requirements don't appear to have been very successful in achieving their objectives. Instead , other performance requirements such as local content requirements or domestic equity requirements may be more effective in transfer of technology.
- Some have expressed the view that domestic equity requirements may adversely affect the extent or quality of technology transfer . However it has been shown that MNEs may not transfer key technologies even tot heir wholly owned subsidiaries abroad fearing the risk of dissipation or diffusion through mobility of employees.
- Also , Indian experience with two wheeler industry shows that domestic equity requirements can really help in technology diffusion.

Reforms & Manufacturing Sector (2017)

R. Nagaraj

Part 1 – Reforms and Global Integration

Introduction

- Manufacturing has emerged as one of the high growth sectors in India. Prime Minister of India, Mr. Narendra Modi, had launched the 'Make in India' program to place India on the world map as a manufacturing hub and give global recognition to the Indian economy.
- India is expected to become the fifth largest manufacturing country in the world by the end of year 2020. Government aims to achieve 25 per cent GDP share and 100 million new jobs in the sector by 2022.
- Achieving these targets require a understanding of industrial achievements in term of periods of high and low growth , its structure and reason for prolonged stagnation.

Industrial achievements and relative performance

- Over a quarter century of market-oriented reforms (1991–2016), the manufacturing (or industrial) sector has grown annually between 7% and 8%
- The growth rate after the reforms is higher than in the preceding quarter century, but it is roughly the same as in the 1980s, when the early reforms were initiated.
- India's share in global merchandise trade has moved up from nearly 0.5% in 2000 to 1.5% by 2015, and the share of services exports rose from 1% to 3% during the same period.
- Industrial production has diversified with perceptible improvements in the quality and variety of goods produced with growing domestic competition. Yet, the manufacturing sector's share has stagnated at about 14%–15% of gross domestic product (GDP) after the reforms .

- Though India has avoided deindustrialization— defined as a decline in the manufacturing (industrial) sector's share in GDP, or share in workforce.
- It stares at a quarter century of stagnation, in contrast to many Asian economies that have moved up the technology ladder with a rising share of manufacturing in domestic output and global trade.
- However, over a longer period, Indian industry has regressed. The telling evidence of it is a comparison with China. Around 1950, both the large Asian giants were roughly at the same level of industrialization . By 2010, China became world's second largest manufacturing nation, and India ranked 10th, producing one-third or one-fourth of China's industrial output

Changing façade of reforms

- The reforms were initially underwritten by structural adjustment loans from the Bretton Woods institutions, conditional upon implementation of the policy changes (as against World Bank's predominant interest in project finance)
- It was built on the initial success in delicensing and import liberalization (that is, a switch from quotas to tariffs) in the 1980s.
- However, deepening of the reforms since the 1990s as part of the broader stabilization and structural adjustment programme, meant a clear departure from the state-led domestic-oriented, capital goods- focused, "heavy" industrialization strategy, towards a market-friendly regime, as advocated by most mainstream economists and development agencies, such as the World Bank (as evident in its official publication, The East Asian Miracle, 1993)

- Though initially centered on industry and trade, culminated in encompassing financial globalization in the last decade, when India got enmeshed in the global economic cycles of boom and bust.
- The public sector was rolled back even within the "conventional confines of utilities and infrastructure" by allowing private and foreign capital in these industries.

Jagdish Bhagwati characterization of pre-reform era policies

- Main elements of India's policy framework that stifled efficiency and growth until the 1970s, and somewhat less so during the 1980s are divided into three major groups:

(1) Extensive bureaucratic controls over production, investment and trade;

(2) Inward-looking trade and foreign investment policies;

(3) A substantial public sector, going well beyond the conventional confines of public utilities and infrastructure.

This gives the impression that reforms meant to drastically change industrial polices but in practice reforms were gradual in nature.

Increasing global integration and its fallouts for India

- India surely rode the boom during its "dream run" for five years from 2003 to 2008, to clock an unprecedented annual economic growth of about 9%, to be counted as among the world's fastest growing large economies .
- Perhaps, with booming services exports, India dreamt of skipping the industrialization stage to be counted as the world's back office, leveraging its large "educated" English-speaking workforce, and ignoring outsourcing services' narrow employment base domestically, and even the slender market segment it was tied to in the financial services sector in the United States.
- If China came to be known as the world's factory, India was reckoned, albeit briefly, as its back office. After the global financial crisis, as with the rest of world, India's boom went bust, with industrial deceleration, rising import dependence, and growing short-term capital inflows financing the balance of payments deficit.

- We are now back to the drawing board, trying to configure how to reindustrialize, given India's persistent economic backwardness (with half of its workforce still engaged in low productive agriculture, and over two-thirds of the population still living in villages) with bleak export prospects, and fickle capital inflows financing its external deficit.

- It is in this context , this paper critically reviews industrial performance and policy after the reforms in 1991, and seeks to address the question of how to get over the stagnation

Reforms & Manufacturing Sector (2017)

R. Nagaraj

Part 2 - Industrial Trends

- Over the entire period of reforms (1991– 2014), the manufacturing sector grew at an annual trend growth rate of 7.7% or 7.2% as per the Annual Survey of Industries (ASI) and Index of Industrial Production (IIP), respectively .
- Evidently, the ASI recorded much wider yearly fluctuations than the IIP, which would show wide differences in the growth rates over shorter periods.

Industrial trends

- It is evident that the 25-year period can be subdivided into three distinct phases: 1992–96, 1997–2003 and 2003–14 .
- The first phase represents the initial euphoria of reforms, with booming output and investment in the anticipation of a virtuous cycle of faster growth and exports.
- However, with the expectations of a boost in demand not being realized, industrial growth decelerated. It coincided with the Asian financial crisis, bust of the dot-com bubble, and freezing of credit markets in the US in the early 2000s.

- The period from 2003 to 2014 represents, as mentioned earlier, the recent debt-led cycle of boom and bust, perhaps best illustrated by the trends in India's and global exports .
- After the global financial crash in 2008–09, fiscal and monetary stimulus domestically and capital inflows on account of quantitative easing (QE) in the advanced economies sustained economic growth until 2011–12 (as also in many emerging market economies), giving rise to a short-lived euphoria of emerging market economies (EMEs) getting "delinked" from the advanced economies

- The industrial growth scenario after 2014 remains hazy on account of unreliable data. While the IIP shows marginal improvement, the new series of the National Accounts Statistics (NAS) reports a distinct upturn—a widely contested statistic.
- The turnaround in industrial and domestic output growth rates are not supported by the trends in (i) credit growth and (ii) capacity utilization in industry.

Performance during boom and bust

- From 1991 to 2003, industrial performance was not particularly impressive. After the initial boom until 1996, there was a nine-year period of deceleration, when the output growth was buffeted by many shocks, such as the Asian financial crisis.
- However, the following cycle of boom and bust (2003–14) was significant in many respects. Five years of India's dream run (2003–04 to 2007–08) were surely led by outsourcing services exports, but manufacturing growth matched the boom with a 10% annual growth rate.
- This was made possible by a steep rise in domestic savings, investment, and capital inflows, boosting the capital formation rate to close to 40% of GDP at the peak of the boom in 2008 . The growth rate recovered after the financial crisis in 2008–09, but at a slower rate of 7.3% per year in the following four years until 2011–12, and decelerated rapidly there after.

- If we look at the average of annual growth rates from 2004–05 to 2013–14, as per the Index of industrial production , for use-based industrial categories.
- In this period, consumer durable goods and capital goods (with each weighing about 8% in the IIP) grew close to 10% per year, while consumer non-durable goods (with a weight of 21%) grew the slowest at 4.2% per year.
- This was also the time when foreign firms and brand names came to dominate many markets, especially consumer durables and capital goods.

- The import to domestic output ratio went up quite sharply in most industries . However, if indirect imports are included, the ratio would go up further.
- In the 2000s, two significant policies were initiated for industrialization, namely, special economic zones (SEZs) and unfreezing of the land market for private industrial and infrastructure investment.
- Until then, export processing zones were set up by the public sector, and land acquisition for infrastructure was their exclusive domain. When these activities were thrown open to private and foreign capital, the results were dramatic.

- The land market quickly got commercialized, with easy access to domestic and international capital, and with property development acquiring primacy over industrial use of land.
- In practice, these policies—meant for promoting industrial exports and infrastructure—quickly became a means of acquiring scarce land, often with state support, from gullible farmers who sold their land cheap or were evicted with the state's connivance, giving rise to the term, "predatory growth" (Bhaduri 2008).
- This resulted in widespread political and social agitations against such policies, contributing little by way of industrial output.

Reforms & Manufacturing Sector (2017)

R. Nagaraj

Part 3 –Reimaging the Role of State

Persistent questions

- How does one understand the foregoing account of industrial performance?
- Many would agree that industry underperformed, but the reasons proffered for it could vary considerably.
- By no stretch of imagination could state policy constrain industrial decision-making any longer. With India's tariff getting reduced, and with numerous bilateral trade and investment treaties, India's openness became comparable to its Asian peers.
- Crucially, if the much derided permit–license raj had held up industrial growth during the planning era, then why did industrial output and exports not zoom after the reforms?

Three Competing explanations

1. Reform Agenda is Incomplete.

2. Labour market is full of rigidity.

3. Ease of doing business need to be improved.

- Before reaching any conclusion, we need to analysis each of these explanations carefully.

More reforms needed

- Protagonists of reforms, however, would contend that the reforms have not gone far enough or the agenda remains incomplete—with restrictions remaining on foreign direct investment (FDI) (especially in retail trade), labour market regulation (in the ability to hire and fi re at will), full convertibility of capital, etc. These arguments seem questionable.
- There is no clear theoretically valid and empirically sound association bet ween pro-market reforms and growth (Rodrik 2011).
- There is perhaps room for critically examining what has been the outcome of the liberalization carried out thus far

- What has India's open-door policy for FDI led to?
- In the last decade, the most significant variety of FDI inflow has been private equity (PE), venture capital (VC), and hedge funds (HF), which are, by definition, loosely regulated alternative investment funds that are part of shadow banking.
- They are not even considered as FDI by the United Nations Conference on Trade and Development definition since they are not for the long-term. Quantitatively, the most important of these sources is PE funds, which, by definition, acquire existing assets and sell these after three–fi ve years in the stock market after restructuring.
- These are hardly the kind of foreign capital that India needs for getting technology and acquiring industrial capability of domestic consumption using foreign debt, not productive investment.

Labour Market Rigidity hypothesis

- The labour market rigidity hypothesis is seriously contested; careful reviews of the literature find little support for the widely held proposition.
- labour market rigidity argument holds little water now can be gauged by the recent news report that Larsen & Toubro, India's largest machinery and construction firm reportedly laid off 14,000 workers (11.2% of its workforce of 1.22 lakh workers) during July–September 2016 (Prasad 2016).
- It amply demonstrates that the "hire and fire" policy effectively rules the organised labour market today. Arguably, the retrenched workers are temporary or contract workers who are not protected by labour laws, which are the bone of contention.
- But, the fact that such a large enterprise employs non-permanent workers in such large numbers only goes to show how the seemingly rigid laws do not apply to a growing segment of organized workers.

Improving "Ease of dong Business"

- Currently, policymakers are using the World Bank's "Ease of Doing Business" (EDB) as a measure of hurdles faced by entrepreneurs, and are busy trying to improve India's global ranking to attract more foreign investment.
- This dubious measure, both conceptually and empirically, hardly explains the foreign investment inflows in developing countries.
- However, do improvements in rankings generate greater foreign direct investment inflows?
- Studies (Jayasuriya 2011) show this relationship is significant for the average country. However, when the sample is restricted to developing countries, the results suggest an improved ranking has, on average, an insignificant (albeit positive) influence on foreign direct investment inflows.

- Additionally, on average, countries that undertake large-scale reforms relative to other countries do not necessarily attract greater foreign direct investment inflows.
- This analysis may have important ramifications for developing country governments wanting to improve their Doing Business Rankings in the hope of attracting foreign direct investment inflows.

Long term constraints on industrial growth

- The answer perhaps lies with the structuralist economic arguments and the long-term constraints, such as less than satisfactory or poor agriculture performance after the reforms .
- Moreover, despite gradual improvements, land productivity in agriculture continues to be a modest fraction of the global average.
- Further, lack of adequate public infrastructure investment (as capacity creation for power generation by proxy) seems to be holding back industrial growth.

Need to reimagine the role of state

- While the foregoing arguments for removing the structural constraints on industrial growth still hold, it is perhaps an opportune moment to revisit the role of state support for industrialization. Admittedly, state intervention during the planning era (1950–80) had many shortcomings.
- Yet, perhaps, the rush to open up markets after 1991 (under stressed macroeconomic conditions) seems to have hurt long-term industrial and trade prospects. So, there seems to be a need to rebalance the equation between the state and the market keeping in view the strategic considerations.

Reorienting industrial & investment policies

- Three aspects of industrial and investment policies that seem to need careful attention are:

(i) long-term finance

(ii) domestic research and development (R&D) efforts

(iii) bilateral investment and trade treaties

India seems to have a disadvantage vis-à-vis its trading partners, especially with respect to China in all these policies.

Long term finance

- As part of financial liberalization, India turned its development financial institutions (DFIs)—such as IDBI (the Industrial Development Bank of India) and ICICI (Industrial Credit and Investment Corporation of India)—into commercial banks, resulting in shortening of loan maturity, thus constraining capital-intensive manufacturing and infrastructure financing.
- The domestic debt market was expected to fill the vacuum, and that has not happened (as in most industrializing countries). In response, large firms were allowed to borrow internationally even for investments in the non-traded goods sector, leading to currency and maturity mismatches, thus raising potential financial instability.
- China, which is still not officially granted the status of a market economy, is known to use cheap credit (including trade credit) as an instrument for penetrating international markets, especially in project exports.

- Commercial sources often suggest that Indian firms are perhaps unable to match the Chinese firms' commercial terms, despite producing goods of comparable quality and variety. This is not new.
- Historically, finance is widely used as an instrument of trade policy. If the above speculation is correct, then there is a case for revisiting national development or investment banks for supply of long-term, low-cost credit for industrial capital formation.
- Such a case has acquired greater urgency in the context of the continuation of the global financial crisis, and the need for public investment to pull the depressed economies out of the present crisis.

Domestic R & D

- Another setback after the industrial reforms has been the decline in domestic industrial R&D. The licenses to import technology and capital in the pre-reform era were conditional upon setting up domestic R&D centers (sweetened with fiscal concessions) to promote indigenous know how.
- After the reforms, firms no longer needed to make such efforts, and foreign firms had no reason to invest in R&D in India that could potentially compete with their parent fi rms' global interests.
- The net result: stagnation in R&D efforts, best illustrated again with a Chinese comparison. In 1996, both China and India spent the same share of their GDP on R&D, at 0.6%.

- However, by 2011, the ratio for China had tripled to 1.8% of GDP, whereas for India the ratio had marginally moved up to 0.8%. Interestingly, despite its liberal FDI policy, China did not take its eyes off the strategic significance of R&D, whereas India perhaps lost its focus in the free market rhetoric (Mani 2016).

Bilateral relations

- At the height of the financial opening-up in the last decade, India signed a large number of bilateral free trade and investment agreements, whose outcome for industry appears to be questionable (Dhar et al 2012- from your first unit reading).
- In particular, the treaty with Thailand, a large base of the Japanese automotive industry, seems to have hurt Indian automotive firms', enabling the duty-free entry of goods. If the observation is correct, then there is perhaps merit in reviewing such agreements.
- This is not to argue for unconditional protectionism or unalloyed faith in the state's capacity to promote industrialization, but to seek for a more reasoned, rule-based support for industry.
- This should not be seen as a plea for putting the clock back; such a view would be ahistorical. What is needed, perhaps, is the redefining and reconfiguring of the boundaries of state and market in view of the changed ground realities, comparative experiences, and the renewed analytical arguments for suitable state intervention