newly-emerged independent nations made a bid for rapid industrialization after the Second World War, the Western nations looked upon this more as being generally contrary to the comparative cost advantages. But very soon India's claims to become an industrial power based on a dynamic interpretation of comparative cost advantage were widely recognized. With the rich and variegated mineral agricultural resource base, the high potential for power generation, the ability of the people to acquire and absorb modern technology and a potentially expanding market for manufactures-both domestic and foreign-very few today dispute India's innate ability to develop as a big industrial power in the world."[8]

### Import Substitution and Export Contribution

Import substitution assumed importance after the Second Plan. Industries with a potential for import substitution have been given great importance. At the beginning of the planning era, India relied very heavily on foreign sources of supply for the requirements of capital goods and a number of basic and other important inputs. In the early decades of planning considerable import substitution took place in many important areas- in capital goods, organic chemicals, pharmaceuticals, dye-stuffs, etc.

However, the manner in which the policy of import substitution has been carried forward has been subject to criticism. *For example*, it has been argued that, "in the Indian context, the emphasis on import substitution has often run counter to the objective of technology development."

The diversification achieved in the industrial sector is reflected in the changing structure of the country's exports. Mention has been made about priority for industries which help exports only in the priority list of the Fifth Plan onwards, and not in those of the earlier plans. However, the Export Policy Resolution of 1970 emphasised the importance of continuous development and expansion of export-oriented production. The share of manufactured products in India's exports has increased significantly.

The Import Substitution Industrialisation Strategy (ISI) followed in India has had several adverse effects. The high protection from foreign competition, a corollary of this strategy, resulted in high costs, poor quality, indifference towards consumers, lack of innovativeness etc. Further, as Manmohan Singh points out, in the mid-1950s, while export industries like jute and cotton textiles were denied foreign exchange for their much needed modernization, a much too liberal approach was followed in India in allocating foreign exchange to many non-essential industries in the name of import substitution.[9] The import restrictions, high costs and poor quality also very severely affected India's export performance.

### Capacity Utilisation

The importance of fully utilising the installed capacity needs no emphasis. Under-utilisation of capacity not only amounts to wastage of scarce resources but also leads to cost-push inflation. It may also create a demand-supply imbalance and affect the balance of trade, employment, saving and investment. Though only the First Plan gave top priority to the fuller utilisation of pre-existing capacity, all other five-year plans included it in the list of priorities. However, capacity utilisation in general has been quite unsatisfactory throughout the plan period.

Of course, some degree of under-utilisation of industrial capacity due to such factors as "planned excess capacity" calculated to meet the demand in the foreseeable future, technological "indivisibilities", which may inevitably create capacity in excess of that warranted by present demand; and initial "testing" troubles of new industries inescapable in the developing economy may have to

be accepted as a normal feature. But India's almost chronic excess industrial capacity should be regarded as something that is due to more fundamental causes, which were not correctly appreciated in Indian Planning.[10] Input shortages, infrastructural bottlenecks and demand problems have been mainly responsible for low capacity utilisation. Improvements in capacity utilisation will, therefore, depend on the developments in the infrastructural sector, input supplies and demand generation. The development of the agricultural sector is important from the point of view of improving input supplies as well as demand generation. It is feared tht the import liberalization may cause flood of imports in some cases , affecting the capacity utilization of domestic firms.

**Regional Disparities**

The removal of regional disparities assumed particular importance since the Third plan. Large public sector industrial investments were made in the backward areas. Incentive schemes were introduced, particularly since the Fourth Plan, to lure private sector enterprises to backward areas. However, much headway could not be made in this direction. One criticism of the new economic policy is that it the backward area development by industrialization is not given importance.

## AN EVALUATION

Despite several problems, the industrial sector of India has made commendable achievements in several respects. Since the commencement of planned development in 1951, India has made significant progress in industrialisation, though the development has been characterised by deficiencies and lopsidedness. Large investments have been made in building up capacity over a wide spectrum of industries; and though India is still primarily an agrarian society, she is one of the majority industrial powers of the world.

As the Seventh Five Year Plan document, reviewing the industrial development after independence, observes, "there has been substantial diversification of the industrial base with the consequent ability now to produce a very broad range of industrial products. Substantial self reliance has been achieved in basic and capital goods industries which now account for as much as one half of the total value added in manufacturing. Indigenous capacities have been established to the point to virtual self-sufficiency so that further expansion in various sectors, such as mining, irrigation, power, transport and communications can be based primarily on indigenous equipment.

Between 1950 and 2000, the index to industrial production registered more than a twenty-two-fold increase, and the share of the secondary sector in the Gross Domestic Product increased from about 13 per cent in 1950-51 to nearly 25 per cent in the five decades of industrialisation since the commencement of planning.

According to Government sources, apart from the quantitative increase in output, the industrial structure has been widely diversified, covering broadly the entire range of consumer, intermediate and capital goods. In most of the manufactured products, the country has achieved a large measure of self-sufficiency, providing the capability to sustain the future growth of vital sectors of the economy primarily through domestic effort. This is reflected in the commodity composition of our international trade, in which the share of imports of manufactured products has steadily declined; on the other hand, industrial products have become a growing component of our exports. Industrial development has been accompanied by a corresponding growth in technological and managerial skills, not only

for the efficient operation of highly complex and sophisticated industrial enterprises but also for their planning, design and construction. Considerable advance has also been made in industrial research and absorbing, adapting and developing industrial technology.

The process of industrialisation has also fostered entrepreneurship and the development of a wide variety of technical, managerial and operative skills. This less visible but critical investment in knowledge places India as a country with one of the largest pools of skilled manpower in the developing world.

The task of achieving the multiple objectives of industrial planning, however, has not been without frustration. The principal failures of planning relate to the inability to utilise the growing potential of the industrial sector and inadequate attention paid to reducing costs and improving quality. The situation, however, has been improving as a result of the economic reforms, although there is still a long way to go.

One of the principal achievements has been the creation of capacity in the basic and heavy industries.

In the last five decades or so, although the industrial output grew at a rate much higher than those for agricultural production and GDP, it lagged very much behind the plan targets. Further, industrial growth in India has been poor compared to several developing countries and her share in the total manufactured output and manufactured exports of developing countries declined very remarkably.

In the initial years of planning industrial development was largely based on import substitution and had the advantage of a captive market. A steady growth could, thus, be maintained. Thereafter, the growth in industrial production was conditioned by the general pace of economic development in the country.

According to the Ninth Plan document, the reasons for the unsatisfactory rate of industrial growth include slow pace of investment especially in infrastructural sectors, lack of demand, inadequate availability and poor quality of infrastructure, global recession leading to slow down in international trade, etc.

**BOX 35.1 : AREAS NEEDING ATTENTION**

According to the Ninth Plan document, the areas needing attention are the following.

- Slow Down in the rate of industrial growth in the recent past.
- Inadequate availability and poor quality of infrastructure.
- Slow down in exports.
- Need to review SSI reservation for critical export industries such as toys, garments and leather goods
- Need for greater flexibility in labour legislation.
- Slow progress of disinvestment of PSEs.
- A very large number of loss-making PSEs; particularly the large number of ironically sick PSEs.
- Regional imbalances in industrial development.
- Unsatisfactory working of BIFR.
- Low investment in domestic R&D; weak linkage of R&D with industry.
- Simplification or streamlining of procedures at State Governments level, especially elimination of multiple local licensing requirements.

varieties of seeds implements and machinery and supply of credit. As a result, there has been a significant increase in the use of modern inputs leading to higher productivity and production.

The agricultural growth rate of around 2.7% per annum in the post-independence period was much higher than the negligible growth rate of 0.3% per annum in the first half of this century. The production of foodgrains increased from 50.8 million tonnes in 1950-51 to about 199.3 million tonnes in 1996-97. The production of commercial crops like cotton, oilseeds, sugarcane, fruits and vegetables, besides livestock products and fisheries has also recorded significant increase during the same period.

*Courtesy:* Planning Commission, *Ninth Five Year Plan.*

## Phases of Development

As the Sixth Five-Year Plan document points out, starting from the beginning of this century, three major phases may be identified in our agricultural evolution.

- The first phase from 1900 to 1947 was marked by a near stagnation in farming, as is clear from a growth rate of about 0.3 per cent per annum achieved in agricultural production during this period.
- Phase II extending from 1950 to 1980, has been marked by considerable advance in the process of modernisation of agriculture, thanks to the steps taken in the development and spread of: *(a)* Technologies based on scientific research; *(b)* Wide range of services; and *(c)* Public policies on land reform, pricing, procurement and distribution. As a result, agricultural production grew at an annual compound rate of 2.8 per cent during 1967-68 to 1978-79.
- The third phase, which has begun in the eighties, is marked by the need for greater attention to marketing and trade, and to institutional frameworks which can help to minimise the handicaps of small and marginal farmers and maximise the benefits of intensive agriculture offered by small holdings.

### BOX 36.2 : THRUST AREAS OF DEVELOPMENT

The thrust areas of agricultural development identified by the Ninth Plan are the following.

- Conservation of land, water and biological resources.
- Rural infrastructure development.
- Development of rainfed agriculture.
- Development of minor irrigation.
- Timely and adequate availability of inputs.
- Increasing flow of credit.
- Enhancing public sector investment.
- Enhanced support for research.
- Effective transfer of technology.
- Support for marketing infrastructure.
- Export promotion.

# EXPANSION AND DEVELOPMENT OF INPUTS AND SERVICES

It has been indisputably proved that input expansion and development in agriculture can bring about a significant output expansion and remarkably increase labour absorption. The agricultural input development strategy has implications for business.

Our Five-Year Plans have emphasised the role of agriculture in national development, and the Central and State Governments have taken a number of steps to develop the agrarian sector. Some of these important measures are reviewed in the following paragraphs.

Irrigation is one of the important inputs that significantly increases agricultural productivity and employment opportunities. The Union and State Governments have been endeavouring to expand the area under irrigation by executing major, medium and minor irrigation projects and exploiting the ground-water potential. Rural electrification programmes, too, have been given importance so that they may help improve agricultural operations by facilitating the energisation of pump-sets, etc. These strategies brighten the prospects of industries which supply inputs for the development of the irrigation infrastructure (like cement, steel etc.), electrification (aluminium cables, steel etc.). It would also increase the demand for electric pump sets and products required for facilitating irrigation like PVC pipes, agricultural implements, insecticides and pesticides, fertilizer, bank credit etc.

Recently, there has been a growing recognition of the role of the private sector in developing irrigation. Private sector participation involves not only the private corporate sector but also groups like farmers' organisations, voluntary bodies and the general public About 90-95 per cent of ground water development is by private efforts either through own financing or institutional financing or both. However, in the case of surface water, especially major and medium projects, all the irrigation projects are not equally endowed with the potential for privatisation and, as such, identification of projects as a whole or partially (*i.e.*, planning and investigation, construction, operation and management financing and maintenance etc.) may have to be undertaken in the light of its viability vis-a-vis various privatization options as available with hydel power generation and recreation, etc. along with irrigation, the viability for privatisation of a project improves.

Some States like Maharashtra. Madhya Pradesh and Andhra Pradesh have initiated the action for privatisation of irrigation projects. These projects are envisaged for privatization on Build-Own-Operate (BOO), or Build-Own-Operate-Transfer (BOOT) or Build-Own-Lease (BOL) basis. In the case of projects on BOO basis, the Irrigation Department may buy water in bulk from the agency at mutually agreed price for distribution to the farmers. Apart from this, resources have been mobilised through issue of Public Bonds from the private market for major projects in several States.

A far-reaching event in the annals of Indian agriculture was the introduction of high-yielding varieties (HYV) of a number of field crops and hybrids of millets in particular. This programme covers major food crops, namely, wheat, rice, *maize, jowar and bajra.* The success of this programme has revolutionised agriculture and brought about a phenomenal and rapid increase in foodgrains production in the country. The high-yielding variety programme is one of the most important planks of the new agricultural strategy. The area under HYV seeds has been showing a progressive increase from year to year. The increasing use of HYVs increases the demand for plant nutrients and protectants like fertilizer insecticides and pesticides. The increase in the agricultural income normally increases the demand for a variety of goods and services.

The regulated market is administered by a committee which represents different interests like the State Government, local institutions, traders, brokers, commission agents and farmers. The committee regulates the various activities connected with sales and purchases in the market. For instance, it issues licences to the functionaries of the market, fixes charges for weighing, brokerage, etc., ensures the use of standard weights and measures, and provides for the supervision and check-up of proper weighing and measuring. There are also arrangements for the settlement of disputes and punishment of the guilty.

The main objective of the regulated market, obviously, is to save the farmers from the exploitation of unscrupulous market intermediaries and to ensure a fair price for their produce.

The regulation of markets is the responsibility of State Governments.

The Directorate of Marketing and Inspection renders advice on framing market legislation and its enforcement.

### Co-operative Marketing

The co-operative sector has been assigned an important role in agricultural marketing too. The National Co-operative Marketing Federation of India (NAFED) has been playing a useful role in this respect.

The co-operative movement has been promoted with the objective of helping the small farmers. Co-operative agencies can play a vital role by arranging to collect the produce of the small farmers, grading and storing it, and helping them to sell at an advantageous price. In short, co-operatives are expected to reduce market imperfections, render the required marketing services and to ensure fair prices. It should be noted that marketing is only one of the important functions of the co-operative sector.

The agricultural marketing infrastructure has not kept pace with the accelerated growth of production in the country. This has resulted in significant post harvest losses of agricultural produce. The Central Government has provided assistance for the creation of infrastructure facilities for marketing and for the setting up of rural godowns. The Ninth Plan proposed to encourage Panchayats also to involve themselves actively in creating marketing infrastructure at the rural level. Marketing extension, being a key factor in bringing desirable changes in attitude, skills and behaviour of the farmers, traders and consumers, it has been proposed to stengthen the agricultural marketing extension. Further, direct marketing has been promoted in the interests of both the producers and the consumers.

## AGRICULTURAL PRICE POLICY

The agricultural price policy is essentially a part of the general price policy which is an important ingredient of the national economic policy. The fact that nearly two-thirds of the Indian population directly depends upon agriculture and that about one-fourth of the national product is generated by this sector indicates the importance of agricultural price policy in India.

The agricultural price policy of the Government of India has three main objectives:

1. To ensure a remunerative price to farmers;
2. To ensure the supply to the consumers at reasonable price; and

3. To establish a structure of relative prices which achieves a desirable cropping pattern.

To achieve the first objective, the Government fixes, from time to time, *Minimum Support Price/Procurement Price* for certain commodities.

The distribution at reasonable prices of certain commodities like food grains procured by the Government at prices fixed by it facilitates the achievement of the second objective. The third objective is achieved by making appropriate variations in the relative price structure.

The Commission for Agricultural Costs and Prices (CACP) recommends to the Government the prices that may be fixed for different agricultural commodities. While recommending the prices, the CACP is guided by the three objectives mentioned above. The policy of the Government, as mentioned above, is that the role of agricultural pricing policy should not be limited only to ensuring remunerative prices to farmers, but should also extend to achieving a better inter-crop balance through a desirable cropping-mix and reducing the existing variability of agricultural production and its consequent effects on the price levels and national income.

Agricultural commodities like wheat and paddy have *procurement prices* fixed for them; the *minimum support price* operates for several commodities—like barley, gram, arhar, moong, urad, mustard, groundnut, sunflower seed, soyabean, and cotton (kapas); and sugarcane, jute and tobacco are subject to *statutory minimum price.*

**BOX 36.3 : POPULIST FODDER**

The Rs 30 a quintal increase in the "minimum support price for wheat" announced last week is plain fodder for runaway populism, and worse. It's a perverse sellout to the farmers' lobby, really. It means further distorting the already massively high-cost, high-subsidy regime which is eating into the vitals of our agricultural economy and clearly decelerating growth, for years. Worse, it is recklessly diverting resources from more productive uses, such as investment in research and extension and vital infrastructure. Note that the increase is wholly against the advice of the Commission for Agricultural Costs and Prices (CACP), yet again. In fact, the CACP's recommendation being summarily cold shouldered by the Centre seems gross; the former's report makes it amply clear that last season's price of Rs 580 a quintal is perfectly reasonable. With good reason, it would seem. Our foodgrain stocks are already upwards of 40 MT, way above prudent levels. But then, for a decade now we have been unwisely hiking procurement prices on the spurious plea of rising costs. In fact it has come to such a pass that domestic prices are now way above international prices!

Meanwhile, in a bid to curtail procurement subsidies the Centre has raised issue prices of grain from the public distribution system. But this has only cut down on offtake from the PDS and jacked up carrying costs. Worse, the open-market prices of wheat are now considerably lower than PDS prices and so defeat the very purpose of high-cost procurement. Notice that the food, read procurement, subsidy bill has almost doubled in the last four years. Concurrently, there is continuing deceleration and decline in public investment. The Agriculture minister says MSP for rabi oilseeds and pulses have been raised to encourage the shift in acreage, from wheat. This seems most unlikely given the unalloyed, politically determined "support" prices for the latter. Surely MSP ought to be no more than a system of covering variable costs of output given the vagaries of the market place (along with other instruments like crop insurance and futures markets). But it certainly must not be reduced to a scheme for handing out wholly questionable giveaways. It goes against the very grain of reforms.

*Courtesy : The Economic Times* (Editorial), 27 June, 2001.

Commodities Suitable for Dealing on Commodity Exchange

A commodity should have the following features if an organised market is to be developed for it.

1. Durability.
2. Classification, standardisation and grading facilities.
3. Large supply and large demand.
4. Uncertainty of supply and demand.
5. Uncontrolled and unrestricted supply and demand, *i.e.,* free competition.
6. Wide fluctuation in price.
7. Adequate storage facilities.

## Spot and Futures Trading

The transaction in a Commodity Exchange can be classified as Spot Trading and Futures Trading.

Spot trading, also known as *cash transaction* or *non-futures transaction,* is a transaction in which the commodity is bought or sold by private transactions involving specific lots and grades for a definite delivery date either for cash or on credit.

The futures trading on a produce exchange refers to contracts for the future delivery of commodities. In futures trading, the commodities themselves are not brought to the futures or forward market; it is only the promises of future delivery, commonly called futures, that are traded.

A future contract can be effected only at the place reserved for this purpose, namely, the Pit or the Ring, and only during the hours prescribed by the exchange.

Hoffman has listed the differences between a spot contract and a futures contract[1] as shown in Table 36.1.

**TABLE 36.1 : CHARACTERISTICS OF SPOT AND FUTURES CONTRACTS**

| | *Cash Contract* | *Future Contract* |
|---|---|---|
| 1 | Is used to market or merchandise the commodity. | Is used to speculate or hedge against price changes of the commodity. |
| 2 | Is executed at tables of the exchange or privately. | Is executed in the pit or ring. |
| 3 | Trades in irregular amounts, *e.g.,* cart-loads or lots of any number of bales. | Trades in round lots, *e.g.,* 1000 bales or 5,000 bushels. |
| 4 | Varying lengths of time used for delivery | A particular future month named is used for delivery. |
| 5 | May or may not have optional period of delivery. | Seller's option of the day of delivery. |
| 6 | Usually calls for specific grade or type of commodity for fulfillment. | Seller's option of grade of a commodity to be delivered. |

Future contracts are standard contracts under the rules of the trading exchange. The contract has to be drawn up in the standard form prescribed by the exchange. It is always subject to the bye-

laws and rules governing futures trading. A futures contract entered into outside the exchange is illegal.

The need for futures trading arises from:

The need for protection against risk of price changes

- The need for stabilising prices
- The need for the price registering function

The primary service of the futures market lies in its provision of a means of insurance against the risks of adverse price fluctuations between the time of the production of the commodity and its final utilisation. The insurance function is carried out by hedging or taking an opposite position on the futures market from that held in the spot market. This enables the market functionaries to charge low rates of commission for their services. The cost of marketing is thus reduced.

A future market, by reducing market imperfections, helps to minimise price fluctuations. Price differences between different places are eliminated or minimised by arbitrage operations carried on by the speculators. A produce exchange collects all the data relevant to the commodity it deals in. A proper dissemination of market information helps to minimise upward or downward price swings, and enables the producers and consumers to sell and buy commodities at more competitive and reasonable prices.

The commodity exchange collects and disseminates information on all the prices of the commodity, including the prices which the speculative investors are willing to pay many months ahead. This ensures in elements of certainity and stability in all the phases of business transactions. This function of the future market acts as a price barometer for producers, industry, exporters, consumers, etc., and enables them to plan their production, trading and other activities more profitably.

While the futures market serves some very useful purpose, it is also susceptible to speculative manipulations which sometimes may turn out to be detrimental to the public interest, particularly of the farmers and consumers.

### Regulation of the Commodity Exchange

Various activities on a commodity exchange are regulated by provisions of certain laws, some of which have been dealt with in some other chapters of this book. There is, however, a specific law designed to regulate the futures trading, a major business on an organised commodity exchange, namely, the Forward Contracts (Regulation) Act.

The Forward Contracts (Regulation) Act was passed by the Government of India in 1952 to enable it to regulate the functioning of the futures market in the national interest.

The Act defines the forward contract "as a contract for the delivery of goods at a future date and which is not a ready delivery contract". The ready delivery contract means, according to the Act, a contract which provides for the delivery of goods and the payment of a price, therefore, either immediately or within such period not exceeding eleven days after the date of the contract and subject to such conditions as the Central Government may, by notification in the official Gazette, specify in respect of any goods, the period under such contract not being capable of extension by the mutual consent of the parties thereto or otherwise.

## SUMMARY

Agriculture which generates about one-fourth of the GDP, one-fifth of the export earnings and on which over sixty per cent of the population depends, is regarded the most crucial sector of the Indian economy. In fact, rural India represents one of the largest potential markets in the world for many manufactured products.

The development strategy and the pattern of resource allocation, and growth rates of the agricultural sector have very important implications for business because of the forward and backward linkages between the primary (mostly agricultural), secondary (industrial) and tertiary (service) sectors.

The agricultural development strategy in Indian planning concentrated, broadly, mostly on:

- Expansion and development of infrastructure, inputs and services.
- Development of agricultural marketing
- Providing price support.

Several measures have been taken by the Central and State governments to develop irrigation, transportation and input and produce storage facilities; improve availability of quality seeds and planting materials, and plant nutrients; and develop new varieties of seeds and plants. A lot of importance is given to agricultural research and extension services.

Agricultural credit is provided mainly by the co-operative structure, with its country-wide network of primary co-operatives, the commercial banks and the Regional Rural Banks (RRBs), are the three main agencies involved in the provision of credit for agriculture and allied sectors. The National Bank for Agriculture and Rural Development (NABARD) was established with a view to bringing about better co-ordination in the credit policies impinging on short, medium and long-term financing of agriculture and allied activities, including marketing, processing and shortage, as well as rural industries.

The agricultural price policy of the Government involves fixing, from time to time, *Minimum Support Price/Procurement Price* for certain commodities. The Commission for Agricultural Costs and Prices (CACP) recommends to the Government the prices that may be fixed for different agricultural commodities. While recommending the prices, the CACP is guided by the three objectives, *viz*., to ensure a remunerative price to farmers; to ensure the supply to the consumers at reasonable price; and to establish a structure of relative prices which achieves a desirable cropping pattern.

An efficient marketing system is essential to protect the interests of the producers, consumers and the economy as a whole. The important objectives of the Government measures to develop agricultural marketing are: 1. A suitable structure of support prices for various agricultural commodities adjusted from time to time in the light of the cost of production so as to ensure fair returns to the farmers. 2. Adequate arrangements for the procurement of agricultural produce at support prices if the prices fall below that level. 3. A well-spread-out and regulated infrastructure of marketing which will ensure a fair price to the producer in open market conditions and help eliminate the non-functional marketing margins of intermediaries. The cooperative sector has been assigned an important role in the marketing of agricultural inputs and output.

One of the important measures taken to develop agricultural marketing is the promotion of Commodity Exchanges. A Commodity Exchange is an organised market where transactions in the sale and purchase of commodities—primary articles like agricultural produce and minerals or manufactured articles—are carried out. In this market, business is transacted according to a prescribed set of rules, and participation in the business is limited to the registered members of an exchange. It is not necessary for the commodities to be physically exchanged; only the rights to ownership are.

Organised markets are an aid to the efficient functioning of an economy, for they help to reduce marketing risks, increase marketing productivity, impart liquidity, provide profitable investment opportunities, augment resources, and so on.

Commodity exchanges in India are known as *recognised associations* under the Forward Contracts (Regulation) Act, 1952.

The transaction in a Commodity Exchange can be classified as Spot Trading and Futures Trading. Spot trading, also known as *cash transaction* or *non-futures transaction*, is a transaction in which the commodity is bought or sold by private transactions involving specific lots and grades for a definite delivery date either for cash or on credit. The futures trading on a produce exchange refers to contracts for the future delivery of commodities. In futures trading, the commodities themselves are not brought to the futures or forward market; it is only the promises of future delivery, commonly called futures, that are traded.

The primary service of the futures market lies in its provision of a means of insurance against the risks of adverse price fluctuations between the time of the production of the commodity and its final utilisation. The insurance function is carried out by hedging or taking an opposite position on the futures market from that held in the spot market. This enables the market functionaries to charge low rates of commission for their services. The cost of marketing is thus reduced. A future market, by reducing market imperfections, helps to minimise price fluctuations. Price differences between different places are eliminated or minimised by arbitrage operations carried on by the speculators. A produce exchange collects all the data relevant to the commodity it deals in. A proper dissemination of market information helps to minimise upward or downward price swings, and enables the producers and consumers to sell and buy commodities at more competitive and reasonable prices.

While the futures market serves some very useful purpose, it is also susceptible to speculative manipulations which sometimes may turn out to be detrimental to the public interest, particularly of the farmers and consumers.

The thrust areas of agricultural development identified by the Ninth Plan (1997–2002) are; conservation of land, water and biological resources; rural infrastructure development; development of rainfed agriculture; development of minor irrigation; timely and adequate availability of inputs; increasing flow of credit; enhancing public sector investment; enhanced support for research; effective transfer of technology; support for marketing infrastructure; and export promotion.

Recognising the need for agricultural sector reforms as part of economic reforms, the Central Government announced on 28th July 2000 a National Agriculture Policy which aims at catapulting agricultural growth to over 4 per cent per annum by 2005. This growth is to be achieved through a combination of measures including structural, institutional, agronomics and tax reforms. Privatisation of agriculture and price protection of farmers in the post-QR regime would be part of the Government's strategy to synergise agricultural growth. The focus of the new policy is on efficient use of resources and technology, adequate availability of credit to farmers and. protecting them from seasonal and price fluctuations.

In view of dismantling of quantitative restrictions (QRs) on imports as per WTO agreement on agriculture, the Policy has recommended formulation of commodity-wise strategies and arrangements to protect farmers from adverse impact of undue price fluctuations in the world market and promote exports.

The Policy proposes to enlarge coverage of futures markets to minimise the wide fluctuations in commodity prices as also for hedging their risks. The policy hoped to achieve sustainable development of agriculture, create gainful employment and raise standards of living.

CHAPTER 37 PART 7

# GATT/WTO AND GLOBAL LIBERALISATION

The global business environment is very significantly influenced by the World Trade Organisation (WTO) principles and agreements. They also affect the domestic environment. *For example,* India has had to substantially liberalise imports, including almost complete removal of quantitative import restrictions.

The liberalisation of imports implies that domestic firms have to face an increasing competition from foreign goods. Liberalisation of foreign investment can result in growing competition from local outfits of MNCs.

These liberalisations, on the other hand, also provides new opportunities for Indian firms as the foreign markets become more open for exports and investments.

The liberalisation also enables Indian firms to seek foreign equity participation and foreign technology. This could help them to expand their business or improve competitiveness.

Further, the liberalisation facilitates global sourcing by Indian firms so that they can improve their competitiveness. Indian suppliers can benefit from global sourcing by foreign firms.

Firms will have to be efficient and dynamic to survive the global competition. Inefficient firms may go out of business.

Consumers stand to benefit significantly from the liberalisation.

## GATT

The General Agreement on Tariffs and Trade (GATT), the predecessor of WTO, was born in 1948 as result of the international desire to liberalise trade.

The Bretton Woods Conference of 1944, which had recommended the IMF and World Bank, had also recommended the establishment of an International Trade Organisation (ITO). Although the IMF and World Bank were established in 1946, the ITO charter was never ratified, because of objections that its enforcement provisions would interfere with the autonomy of domestic policy making. Instead, the GATT, which had been drawn up only as an interim agreement to fill the gap until the ITO charter was ratified, became the framework for international trading system since it came into being in 1948. The international trading system since 1948 was, at least in principle, guided by the rules and procedures agreed to by the signatories to the GATT which was an agreement

Further, the exports of developing countries gained significantly less from the GATT Rounds than did exports of the industrial nations. The trade liberalisation has been confined mostly to goods of interest to the developed countries. In case of agricultural commodities not only was that there was no liberalisation, but also there was an increase in protection. Manufactured products of interest to developing countries like textiles and clothing, footwear etc. have been subject to increasing non-tariff barriers. While the developed countries enjoy a more liberalised trading environment, the growing NTBs have been severely affecting the exports of developing countries. Ironically, the developed countries are increasing the protectionism when the developing countries are liberalising. This is indeed a sad commentary on the GATT and other multilateral organisations.

## THE URUGUAY ROUND

Uruguay Round (UR) is the name by which the eighth and the latest Round of the multilateral trade negotiations (MTNs) held under the auspices of the GATT is popularly known because it was launched in Punta del Este in Uruguay, a developing country, in September 1986.

Because of the complexities of the issues involved and the conflicts of interests among the participating countries, the Uruguay Round could not be concluded in December 1990 as was originally scheduled. When the negotiations dragged on, Arther Dunkel, the then Director General of GATT, presented a Draft Act embodying what he thought was the result of the Uruguay Round. This came to be popularly known as the Dunkel Draft. This was replaced by an enlarged and modified final text which was approved by delegations from the member countries of the GATT on 15th December 1993. This Final Act was signed by ministers of 125 governments on 15th April 1994. The results of the Uruguay Round are to be implemented within ten years since 1995. Different time periods are given for effecting the different agreements.

The first six Rounds of MTNs concentrated almost exclusively on reducing tariffs, while the Seventh Round (Tokyo Round-1973-79) moved on to tackle non-tariff barriers (NTBs). The UR sought to broaden the scope of MTNs far wider by including new areas such as:

- Trade in services
- Trade related aspects of intellectual property (TRIPs)
- Trade related investment measures (TRIMs).

Because of the inclusion of these new aspects in the GATT negotiations, the developing countries had serious apprehensions, about outcome of the Uruguay Round.

The Uruguay Round took up three basic subjects for discussion:

1. Reducing specific trade barriers and improving market access.
2. Strengthening GATT disciplines.
3. Problems of liberalisation of trade in services, trade related aspects of intellectual property rights (TRIPs) and trade related investment measures (TRIMs).

The most outstanding feature of the UR was the inclusion of the subjects in the 3rd item referred to above in the MTNs of GATT. The traditional concerns of the GATT were limited to international trade in goods. The UR went much beyond goods to services, technology, investment and information.

Some of the important features of the Uruguay Round Agreements are given below.

## GATT and WTO

Following the UR Agreement, GATT was converted from a provisional agreement into a formal international organisation called World Trade Organisation (WTO) with effect from January 1, 1995. WTO now serves as a single institutional framework encompassing GATT and all the results of the Uruguay Round. It is directed by a Ministerial Conference that will meet at least once every two years and its regular business is overseen by a General Council.

The old GATT system allowed, under what was known as the 'grandfather clause', existing domestic legislation to continue even if it violated a GATT agreement that a member country had accepted by being a signatory to GATT. The WTO, specially rules this out.

The situation, after the coming into effect of WTO may be described as *the GATT is dead, long live the GATT.*

Under the old system, there were two GATTs: *(i)* GATT the Agreement — *i.e.,* the agreement between contracting parties (governments) setting out the rules for conducting international trade; *(ii)* GATT the Organisation—an international organisation created to facilitate discussions and administration related to the Agreement (ad hoc, though, continued to exist until the establishment of the WTO). GATT the organisation, ceased to exist with the establishment of WTO; GATT the agreement, which always dealt with (and still does) trade in goods, continues to exist, in amended form, as part of the WTO alongside two new agreements, *viz.,* General Agreement on Trade in Services (GATS) and General Agreement on Trade Related Aspects of Intellectual Property Rights (TRIPs). The old text is now called 'GATT 1947' and the updated version is called 'GATT 1994'. *In short, the WTO is GATT plus a lot more.*

**TABLE 37.1 : DIFFERENCE BETWEEN GATT AND WTO**

| GATT | WTO |
|---|---|
| GATT was ad hoc and provisional | WTO and its agreements are permanent |
| GATT had contracting parties | WTO has members |
| GATT system allowed existing domestic legislation to continue even if it violated a GATT agreement | WTO does not permit this |
| GATT was less powerful, dispute settlement system was slow and less efficient, its ruling could be easily blocked | WTO is more powerful than GATT, dispute settlement mechanism is faster and more efficient, very difficult to block the rulings. |

## Functions

The WTO has the following five specific functions.

1. The WTO shall facilitate the implementation, administration and operation and further the objectives of the Multilateral Trade Agreements and shall also provide the framework for the implementation, administration and operation of plurilateral Trade Agreements.
2. The WTO shall provide the forum for negotiations among its members concerning their multilateral trade relations in matters dealt with under the Agreements.
3. The WTO shall administer the 'Understanding on Rules and Procedures Governing the Settlement of Disputes'
4. The WTO shall administer the 'Trade Review Mechanism'

Industrial countries are then to reduce their tariff bindings by an average of 36 per cent within six years (from 1995) while all developing countries but the poorest are required to reduce tariffs by an average of 24 per cent over a period of ten years. Least developed countries are not required to make any commitment for reduction of tariffs on agricultural products.

On agricultural tariffs, developing countries have the flexibility of indicating maximum ceiling binding. India has indicated ceiling bindings of 100 per cent on primary products and 300 per cent on edible oils.

***Subsidies and Domestic Support Policies:*** The UR Agreement deals with three categories of subsidies.

1. *Prohibited subsidies* – those contingent upon export performance or the use of domestic instead of imported goods.

2. *Actionable subsidies* – those that have demonstrably adverse effects on other member countries.

3. *Non-actionable subsidies* including those provided (with stipulated limitations) to industrial research and procompetitive development activity to disadvantaged regions, or to existing facilities to adapt themselves to new environmental requirements.

The Agreement also puts restrictions on the use of countervailing measures against competitors' subsidies. To prevent undue hardships, developing countries and countries in transition from centrally planned to market economies are allowed extra time to bring the subsidies into conformity with the new rules.

While industrial economies are required to reduce, over six years, the volume of subsidised agricultural exports by at least 21 per cent and the value of subsidies at least by 36 per cent, the respective figures for developing countries are 14 per cent and 24 per cent. All countries are bound not to introduce new subsidies.

The UR agreement has brought the domestic support policies also under the multilateral trade discipline. However, domestic support measures that have almost a minimal impact on trade ("green box" policies) such as general government services in the areas of research, disease control, infrastructure and food security as also certain direct payments such as certain income support policies, structural adjustment assistance, payment under environmental programmes and regional assistance programmes are exempted. The non-exempted types of subsidies included in the aggregate measure of support (AMS) required to be reduced include assistance in the form of production-limiting subsidies and assistance given for growth of agriculture and rural development like procurement at support prices and subsidies on inputs and credit. However, even these subsidies are required to be reduced only if their total amount as a proportion of the value of agricultural production exceeds five per cent in case of developed countries and 10 per cent in case of developing countries. If the non-exempted subsidies are above these limits, they are required to be reduced by 20 per cent in case of developed countries and by 13.3 per cent in developing countries by 1999.

According to government of India, India's total AMS is negative (without taking into account exemptions available on input subsidies to low income and resource poor farmers) and there are no reduction commitments. Nor does India have any minimum market access commitments in agriculture. (The UR Agreement provides for the establishment of minimum access tariff quotas, at reduced tariff rates, where the access is less than 3 per cent of the domestic consumption. The minimum access tariff quotas are to be expanded to five per cent over the implementation period).

Assistance for 'food security" such as the food subsidy under the public distribution system (PDS) will be exempted to the extent they confine to the poor.

**Non-agricultural Export Subsidies**

Countries whose per capita income is less than $1000 are not bound to phase out export subsidies. (India's per capita income in 2000 was only $460). However, even such countries will have to phase out export subsidies on products where the share in the world exports is 3.25 per cent or more in two consecutive years. This is applicable to India in respect of exports of diamonds.

## GATS

The General Agreement on Trade in Services (GATS) which extends multilateral rules and disciplines to services is regarded as a landmark achievement of the UR, although it achieved only little in terms of immediate liberalisation.

Because of the special characteristics and the socio-economic and political implications of certain services, they have been generally subject to various types of national restrictions. Protective measures include visa requirements, investment regulations, restrictions on repatriation, marketing regulations, restrictions on employment of foreigners, compulsions to use local facilities etc. Heavily protected services in different countries include banking and insurance; transportation; television, radio, film and other forms of communication; and so on.

The GATS defines services as the supply of a service from the territory of one member (country) into the territory of any other member; in the territory of one member to the service consumer of any other member; by a service supplier of one member, through commercial presence in the territory of any other member; or by a service supplier of one member, through presence of natural persons of a member in the territory of any other member.

In short, the GATS covers four modes of international delivery of services.

1. Cross-border supply (transborder data flows, transportation services)
2. Commercial presence (provision of services abroad through FDI or representative offices).
3. Consumption abroad (tourism)
4. Movement of personnel (entry and temporary stay of foreign consultants)

While industrial countries have offered market access commitment of some kind on over half (about 54 per cent) of their service activities, developing countries did so only on less than one-fifth (about 17 per cent) of their service categories. Tourism and travel-related services are the only activities in which a substantial number of developing countries made commitments.

The framework of GATS includes basic obligation of all member countries on international trade in services, including financial services, telecommunications, transport, audio visual, tourism, and professional services, as well as movement of workers.

Among the obligations is a most favoured nation (MFN) obligation that essentially prevents countries from discriminating among foreign suppliers of services.

Another obligation is the transparency requirements according to which each member country shall promptly publish all its relevant laws and regulations pertaining to services including international agreements pertaining to trade in services to which the member is a signatory. Further,

Safeguard measures would not be applicable to developing countries where their share in the member country's imports of the product concerned is relatively small.

## EVALUATION OF THE URUGUAY ROUND

The Uruguay Round was by far the most complex and controversial one. The fact that it took more than seven years to complete the negotiations as against the originally contemplated more than four years indicates the complexities involved. It is the inclusion of new areas like TRIPs, TRIMs, services and the attempts to liberalize agricultural trade and the elimination of NTBs like MFA that increased the complexity of the negotiations.

The success of the UR Agreement will depend upon the spirit with which it will be translated into practice. The tariffication of trade barriers was claimed to be a significant success of the UR. However, because of the way the NTBs were converted into tariffs, the so-called dirty tariffication, many of the tariff bindings exceeded the protection rate applying during the base period (which itself was one of generally high level of protection), some by as much as 200 per cent.

Several estimates of the gains from the UR Agreement are available. They vary widely. According to some estimates the real world income (in constant 1992 US dollar) will increase by between $212 billion and $274 billion in 2005. Further, such annual increases will follow. This amounts to around one percent of World GDP. According to a GATT study, the gain will be as high as $510 billion.

Most of the gains will accrue to the developed countries. Some developing countries in the category of least developed countries and net food importers are expected to lose because of the Uruguay Round package.

According to some estimates the increase in real income will be roughly 1.6 per cent of GDP for the European Union, 0.2 per cent for the US and 0.9 for Japan. As a single country, the largest gain in absolute terms will accrue to the US (between $28 and $67 billion). It will be between $27 and $42 billion for Japan, between $61 and $98 billion for the EU and between $36 and $78 billion for the developing countries. The gains would amount to about 2.5 per cent of the GDP for China, 0.5 per cent for India, 0.6 per cent for South Africa and 0.3 per cent for Brazil.

According to GATT estimates, World trade would increase by 12 per cent (on top of the normal growth rate), if the UR package is completely implemented. In constant 1992 US dollars, this represents an increase of $745 billion. The value of world exports (including services) will increase by around 10 per cent. Exports of North America will increase by 8 per cent and European Union by 10.3 per cent. Some of the largest projected increases in world trade are in areas that are of interest to developing countries. For instance, world trade in textiles is projected to grow by 34 per cent, that in clothing by 60 per cent and that in agricultural, forestry and fishery products by 20 per cent.

According to the estimates made by the World Bank, OECD and the GATT Secretariat the income effects of the implementation of UR package will add between $213 to 274 billion annually to world income. The GATT Secretariat's estimate of the overall trade impact is that the level of merchandise trade in goods will be higher by $745 billion in the year 2005, than it would otherwise have been. The largest increase will be in the areas of clothing (60 percent), agriculture, forestry and fishery products (20 per cent) and processed food and beverages (19 per cent). Since India's existing potential export competitiveness lies to a significant extent in these product groups, India could be expected to obtain gains in these sectors.

According to one estimate, cuts in protection on total merchandise trade will increase real incomes in developing countries by $55 to 90 billion (or 1.2 to 2 per cent of their GDP in 1992) while the gains to the world as a whole will be in the order of $200 billion.

## UR AGREEMENT AND DEVELOPING COUNTRIES

As in the case of the previous Rounds, the developing countries, in general, are dissatisfied with the outcome of the Uruguay Round. The Wall Street Journal has reported that while the US and the EC are getting the best pieces of the world trade pie, the developing countries are getting the crumbs.

Some of the areas like TRIPs, TRIMs and services have been very sensitive as far as the developing countries are concerned as the Uruguay Round Agreements in them mean that the developing countries will have to lower the protection against competition from the unequal developed economies. However, as in the previous Rounds, the UR also gives special considerations to developing countries, particularly to the least developed countries and to those with balance of payments problems. The Agreement, however, lays down that member countries imposing trade restrictions for balance of payment purposes should do so in a way that causes minimum disruption to international trade and quantitative restrictions should be avoided as far as possible.

Indeed, it would be the developed countries who would suffer most by liberalisation of the agricultural sector. But to argue that the developed countries should completely liberalise agriculture without any reciprocity on part of the developing countries is clearly illogical. As a matter of fact, the UR proposals in respect of agriculture, as in several other cases, give special consideration to the developing countries. Developed countries will, however, be hit hard. *For example,* agricultural subsidies in the European countries have been of the order of 30 to 50 per cent.

While the liberalisation of agricultural trade and the increase in agricultural prices due to cut in producer subsidies in the developed countries would benefit agricultural exporters, the increase in food prices due to cut in subsidies may adversely affect the food importers. More than 100 of the developing nations are reported to be net food importers. However, the increase in food prices should be expected to make food production in these countries more competitive leading to an increase in production. It may be noted here that it has been alleged that the subsidisation of production and export of farm production in the developed countries would have the effect of discouraging their production in the developing countries where farmers have not been able to compete with the imported stuff bearing artificially low price because of the subsidies. It is estimated that since subsidised agricultural exports cannot be dumped on the world market, international agricultural prices could go up by as much as 10 per cent.

One of the major areas of disappointment for many developing countries is trade in textiles. Textiles is one of their most important export items but developed countries have been following a very restrictive import policy. The developing countries wanted a fast phasing out of the multifibre arrangement (MFA) under which the textile imports have been restricted. However, the MFA will be phased out, in stages, over a 10 year period and a major part of the liberalisation will take place only towards the end of the transitional period. A little consolation for the developing countries is that the US demand for extending the phase out period to 15 years was not accepted.

International trade in textiles is estimated to be worth $240 billion a year. Estimates are that after the phasing out of MFA, world exports of textiles may go up by $25 billion a year. With a 2.2 per cent share in the world textile trade, India's share in the additional exports could be $0.55 billion. But the real gain will depend on the country's ability to compete with countries like China, Hong Kong, Taiwan, South Korea, etc. which are considered leaders in the textile trade.

unfortunately belated realization that developing countries were short-changed in the Uruguay Round negotiations. What is at stake is the very credibility of the international trading system in the eyes of the developing countries. Resolution of the implementation issues is the only way to restore credibility"[5].

## UR AGREEMENT AND INDIA

The Uruguay Round Agreements have come in for scathing criticisms in India. Many politicians and others have argued that India should withdraw from the GATT. Most of the criticisms are either baseless or due to lack of knowledge of the international trading environment, and misinformation, or are just meant to oppose the government by the opposition parties.

It is true that the Round mostly benefits the developed countries. That does not mean that developing countries like India are losing – only that their gain is limited as compared to that of the developed countries.

Accepting the demand of some of the critics, that India should withdraw from the WTO will be a great blunder that the nation can commit. By being a part of WTO India enjoys the most favoured nation (MFN) status with all the other members of the WTO. Opting out of the system would mean an infinitely laborious task of entering into bilateral negotiations with each and every one of the trading partners which would amount to "having one's arms twisted bilaterally by the US, the EC and Japan, turn by turn, on everything from intellectual property rights to NPT, human rights and environmentally clean technologies for packaging."[6] It may be noted at this juncture that countries like China are waiting impatiently to get admitted to the WTO.

One major controversy of GATT is the agricultural subsidies. Much hue and cry have been raised in India about this factor. However, it needs to be mentioned that the GATT decision would not adversely affect India's agricultural subsidies and its agriculture exports. Other developing countries would also largely benefit because of the lowering of the agricultural protection by the developed countries, in spite of the fact that the wish of the developing countries that the major Western nations would totally drop subsidies for their producers, substantially lower tariffs, and open markets did not materialise

According to Government of India, the Market Access Agreements signed by India with the USA and EU will result in additional export earnings of around Rs.1100 crores in the initial years and the additional access achieved will get magnified in the second and third phases of integration of the textiles trade with the multinational trade system and will provide larger earnings during these periods.

Assuming that India's market share in world exports improves to one per cent, and that she is able to take advantage of the opportunities that are created, the trade gains may consequently be placed at $2.7 billion exports per year. More generous estimates range from $3.5 to 7 billion worth of extra exports.

However, India's gain will be much less than those of several other developing countries like China and the newly industrialised economies because: *(i)* India's share in the world trade is very low *(ii)* The foreign trade-DGP ratio of India is low. The gain will also depend on the rate of growth of India's exports.

## SUMMARY

The principles and Agreements of WTO have very significant impact on the business environment. Figure 37.1 provides a bird's eye view of the important impacts.

The salient features of the Uruguay Round Agreement are given below.

1. The Uruguay Round substantially expanded the scope of multilateral trade negotiation by including services, intellectual property rights (TRIPs) and trade related aspects of investment measures (TRIMs), as against only goods in the past.
2. With effect from January 1, 1995, GATT (which was temporary an ad hoc) was replaced by a permanent organisation, the WTO.
3. WTO is GATT plus a lot more. Under the GATT there was only one major agreement—GATT. Under the WTO, there are agreements related to three major areas—GATT, GATS and TRIPs.
4. WTO is a more powerful and effective organisation than GATT. It has a more effective dispute settlement mechanism.
5. The Uruguay Round Agreement seeks to liberalise trade in manufactures by enlarging tariff bindings, reducing tariffs and removing tariffs.

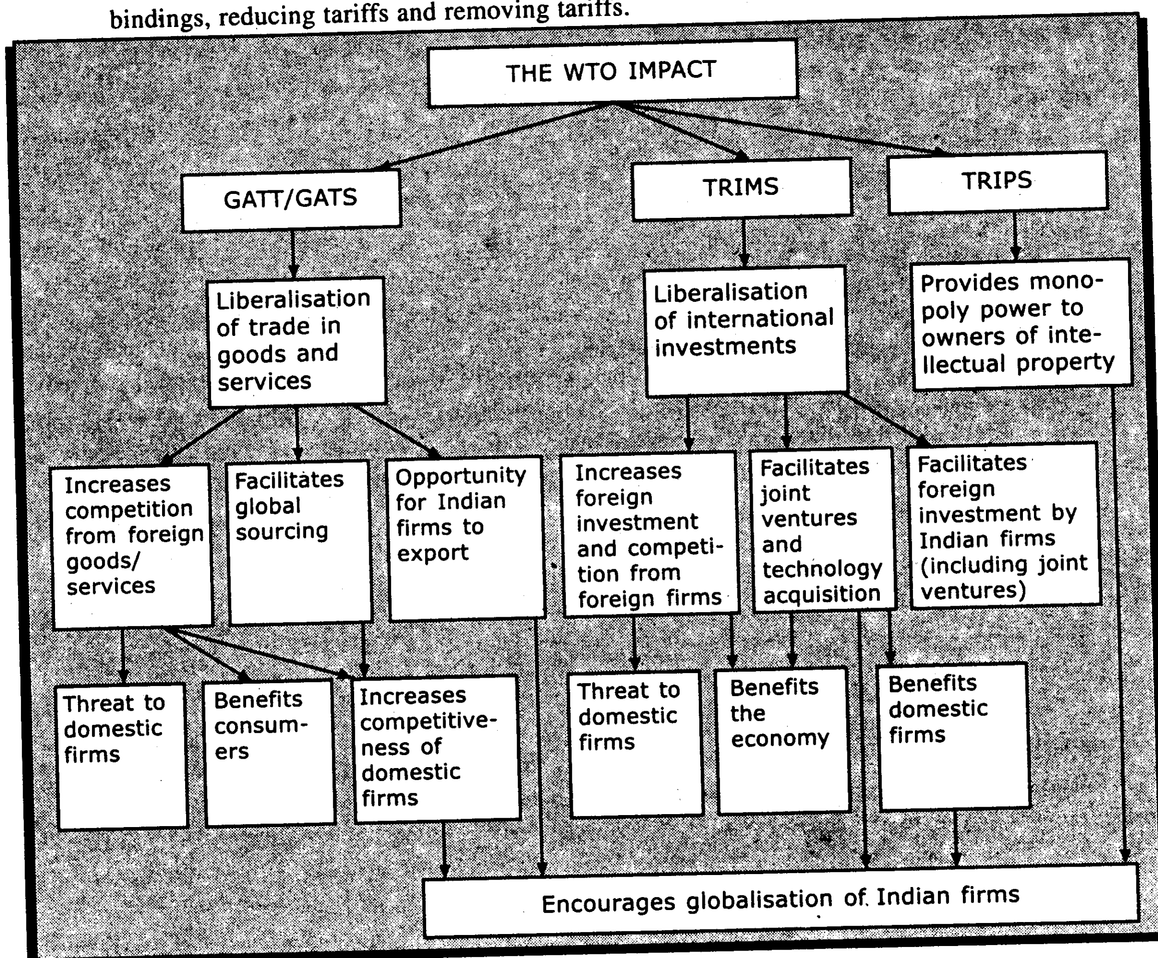


*Fig. 37.1 : The WTO Impact*

**BOX 37.2 : INDIA AND DOHA MEET**

| India opposed these | India's concerns before Doha | India's Achievements after Doha |
|---|---|---|
| Investment | Right to development-oriented FDI policies and to screen investments may be lost. | Have got time till 2003. The issue is included in the new round, but, India can stall the negotiations if it can gather sufficient support. |
| Competition policy | Can have crosscutting implications for negotiations in other agreements. | Same as above |
| Transparency in Government procurement | 'Development dimension' of public procurement may get compromised | Same as above |
| Trade facilitation | Modernisation of customs procedures done already. Fear of losing revenue | Same as above |
| Environment | Could be misused as barrier | Same as above |
| Agriculture | Developed countries need to comply too | EU agreed that the ultimate goal of negotiations on agriculture will be phasing out farm export subsidies |
| TRIPs | Ability to maintain public health could be hurt | Developing countries can now produce drugs inexpensively but only for an emergency. |

*Courtesy :* Nikhil Gupta, *"Need for Strategy", A&M,* 15 November 2001.

CHAPTER 38 — PART 7

# INTERNATIONAL INVESTMENTS

The economic liberalisations that swept across the world, particularly since the late 1980s, have very significantly changed the environment for international investments. At the same time, the surging international capital flows, in its turn, are substantially impacting the business environment.

As Peter Drucker in his *Managing For the Future* observes, "increasingly world investment rather than world trade will be driving the international economy. Exchange rates, taxes, and legal rules will become more important than wage rates and tariffs."[1]

**BOX 38.1 : EXPANSION OF FOREIGN INVESTMENT**

The expansion of international investment has been facilitated by virtually all countries through changes in their regulatory environments. *For example*, over the period 1991-1999, 94 per cent of the 1,035 changes worldwide in the laws governing foreign direct investment (FDI) created a more favourable framework for FDI. Complementing the more welcoming national FDI regimes, the number of bilateral investment treaties—concluded increasingly also between developing countries—has risen very substantially. Double taxation treaties have also increased. At the regional and inter-regional levels, an increasing number of agreements is helping to create an investment environment more conducive to international investment flows.

The ratio of world FDI inflows to global gross domestic capital formation was 14 per cent in 1999, compared with 2 per cent twenty years ago. Similarly, the ratio of world FDI stock to world GDP increased from 5 per cent to 16 per cent during the same period.

The ascendance and deepening of international production have given rise to new policy challenges.

The distribution of international production, and of the corresponding benefits associated with it, are some of the most important of these. While the size of international production has risen significantly over the past few decades, not all countries have participated in it to the same extent. FDI, albeit an imperfect measure of international production, is concentrated in a handful of countries—ten countries received 74 per cent of global FDI flows in 1999. Just ten developing countries received 80 per cent of total FDI flows to the developing world. More importantly, there are no signs that the concentration of international production across countries has been declining over time. However, in many least developed countries that have received only small amounts of FDI, such investment is important vis-a-vis the size of domestic investment. What remains a challenge for these countries is the ability to attract not only more, but also higher quality FDI—broadly defined as investment with strong links to the domestic economy, export orientation, advanced technology and skill or spillover effects.

*Courtesy:* UNDP, *World Investment Report, 2000.*

There are mainly two routes of portfolio investments in India, *viz.*, by Foreign Institutional Investors (FIIs) like mutual funds and through Global Depository Receipts (GDRs), American Depository Receipts (ADRs) and Foreign Currency Convertible Bonds (FCCBs). (It may be pointed out here that some Government of India publications classify ADRs/GDRs as FDI, whereas some other GOI publications regard them portfolio investments. It is difficult to agree with the former view).

GDRs/ADRs and FCCBs are instruments issued by Indian companies in the foreign markets for mobilising foreign capital by facilitating portfolio investment by foreigners in Indian securities. Since 1992, Indian companies, satisfying certain conditions, are allowed to access foreign capital markets by Euro issues.

With reference to foreign investment in India, foreign investment may be classified as shown in *Fig. 38.1.*

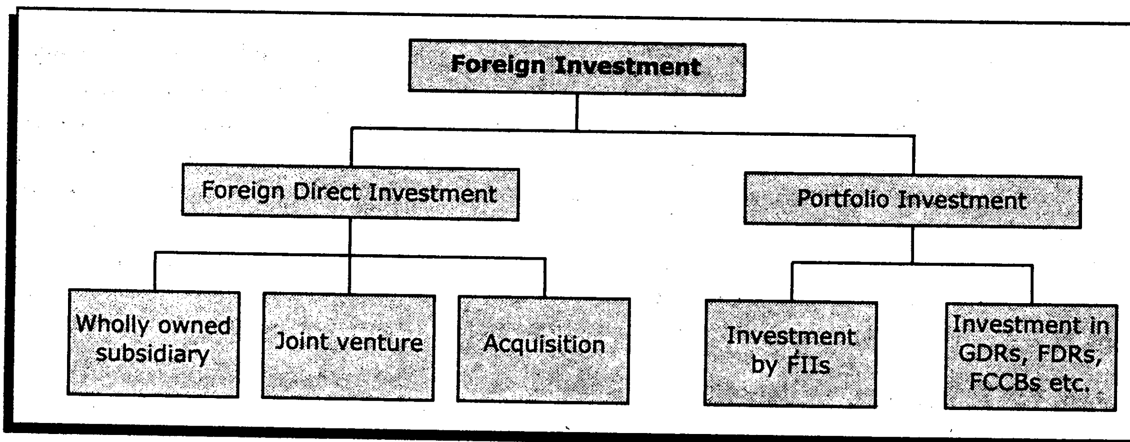


*Fig. 38.1 : Types of Foreign Investment*

## FACTORS AFFECTING INTERNATIONAL INVESTMENT

International investments are influenced by a number of factors.

**BOX 38.2 : 12 COMMANDMENTS OF FOREIGN DIRECT INVESTMENT**

1. *Stable, predictable macro economic policy.* Companies must have the confidence that the economy in which they make an investment will be managed in a competent and predictable way. Simply stated, investors must believe that the rules of the game will not change in the middle of a contest.
2. *An effective and honest government.* An investor must be able to rely upon the integrity of the host government and its ability to maintain law and order.
3. *A large and growing market.* The size and potential for growth of a country's domestic market, especially the purchasing power of its customers, are key. Companies do not seek to invest in a market where there is little potential to make a profit.
4. *Freedom of activity in the market.* The strength of the competition, as well as the degree of government (theirs and ours) interference to enter a country's market, are important factors. The freer the market, the more attractive it becomes as an investment site for international investors.

5. *Minimal government regulation.* The cost of government regulation and intervention in the affairs—and profits—of private companies must be kept to a minimum.
6. *Property rights and protection.* Private property must be protected. The likelihood that a company's real or intangible (patents, copy-rights, etc.) property will be stolen must be avoided.
7. *Reliable "infrastructure."* The ability to consummate transactions and get products and services to market is also critical. Whether it be reliable transportation, power generation, insurance and accounting services, a competent financial system or other basic factors, investments cannot yield a sufficient or reliable financial return without them.
8. *Availability of high-quality factors of production.* While the investor brings capital, technology and management to the table, the quality of the indigenous work force and the availability of local raw materials are also key ingredients in the recipe for success.
9. *A strong local currency.* The local currency must retain its value. If you make an investment in dollars and then the local assets (valued in the local currency) are devalued, you have lost part—or possibly all—of your original dollar-based investment.
10. The *ability to remit profits, dividends and interest.* If you cannot get your money out of the country, why invest?
11. *A favourable tax climate.* Although tax incentives geared to attract initial investments are important, a company's final investment decision is usually based on how a country's taxation will affect the normal operating environment once the venture is off the ground.
12. *Freedom to operate between markets.* A company must be able to source goods and services from its operating unit in one market in order to serve other markets or to maximize its global efficiency by trading among its operating entities in different countries to "round out" its product lines.

*Courtesy:* John D Sullivan, "Prospering in the Global Economy", *Economic Reform Today*, No.1, 2000.

### Host Country Economic Determinants

Traditionally, the economic determinants of inward FDI have been grouped, for analytical convenience, into three clusters, each of them reflecting the principal motivations of investing in foreign countries: *resources seeking; market seeking* and *efficiency seeking.*

***Resources:*** Historically, the most important motivation of FDI has been the exploitation of natural resources. Dunning points out that in the nineteenth century, much of the FDI by European, United States and Japanese firms was promoted by the need to secure an economic and reliable source of minerals, primary products for the investing industrialising nations of Europe and North America. Up to the eve of the Second World War, about 60 per cent of the world stock of FDI was in natural resources. The post war period, particularly since the 1960s and 1970s, witnessed a decline in the share of natural resources in the FDI. Besides the decline in the importance of the primary sector in world output, this decline was caused by factors such the development of the indigenous enterprises in this sector. In a number of developing economies the public sector came to play an important role in the resources based industries. Public sector efforts also included equity or technical collaborations with MNCs.[3]

Although, the share of the primary sector in FDI has declined, there has been a substantial increase of the FDI in this sector in absolute terms. The FDI stock in the primary sector of developed countries increased more than five-fold between 1975-1990, while in the developing countries it increased more than six-fold. According to the *World Investment Report 1998*, though declining in

importance, the availability of natural resources is still a determinant of FDI and continues to offer important possibilities for inward investment in resource–rich countries. Natural resources still explain much of the inward FDI in a number of countries, developing (e.g. countries in sub-Sahara, Africa), developed (e.g. Australia) and countries in transition (Azerbaijan, Kazakhistan and Russian Federation).[4]

***Markets:*** Another important traditional determinant of FDI has been market seeking. Markets protected from international competition by high tariffs or quotas triggered *tariff jumping* FDI. Dunning points out that market access became the predeterminant motive for investing in the manufacturing sector of developed countries between the two world wars and of developing countries in the 1960s and 1970s, during the heyday of import substitution industrialisation. This motive was paramount, *for example*, in the wave of United States investments in Europe, especially in the United Kingdom, during the early post-war period and in Japanese investments in the United States after the mid 1980s, following voluntary export restrictions and the possibility of further protectionist measures in the automobile industry.[5]

It is very relevant to note here that the largest market in the world, the U.S, is the largest recipient of FDI, followed by China, a huge market by the size of the economy, population and very high economic growth rate. As UNCTAD points out, some of the largest national markets remain unmatched in size by the largest regional markets or even by entire continents. *For example*, the market of the European Union during most of its existence has been smaller than the United States market; the market of the African continent (without South Africa) is smaller than that of Republic of Korea; and the combined markets of the 14 Central and Eastern European countries are smaller than the market of Brazil.[6]

The lion's share of FDI flow to the developing countries goes to the larger markets with comparatively good infrastructure and political stability in general.

The growing importance of the service sector has also been resulting in increasing FDI because of the fact that most services are not tradable and, therefore, the only way to deliver them to foreign markets is through establishment abroad. However, the highly regulated nature of the services sector has been a deterrent to the FDI flow in its full potential.

***Efficiency:*** Another important motivation of FDI is efficiency seeking. Low cost of production, deriving mostly from cheap labour, is the driving force of many FDIs in developing countries. Export processing zones have been developed by developing countries mostly to take advantage of the efficiency seeking FDI flows.

It may be noted that the presence of any of the three determinants mentioned above alone need not attract FDI. *For example*, even if a country has natural resources or abundance of cheap labour, FDI would not take place in the absence of required infrastructural facilities to develop the industry or trade. Besides, several other factors like the political environment, government policies, bureaucratic culture, social climate etc. are also important determinants of FDI.

## GROWTH OF FOREIGN INVESTMENT

Following the sweeping changes in the economic policy, foreign investment has been surging in many countries. Foreign drect investment (FDI) has increased from $21.5 billion in 1973, to $1271 billion in 2000.