WIRC OF ICAI

Virtual CPE Meeting on

Practical Aspects of
FDI &
Import Substitution
A Global Perspective with Indian Focus.

Key Note Address by
Rashmin Chandulal Sanghvi

29th August, 2020
Mumbai

Note: Some views expressed here are different from popular views.
All views are exclusively my personal views.

We will focus on Indian economy and look at Chinese & US economies to compare & contrast. This exercise can bring out new meanings to the concepts of Import Substitution and FDI. My Key Note address is on Concepts. Legal details will be explained by two experts soon after my talk.

A. Both – Import Substitution & FDI considered together.

Notes: I have prepared a brief note on a vast subject. But even this will be too long for a fifteen minute address. I am sending two separate notes to WIRC office. (i) Short version for 15 minutes. (ii) Longer version that may take 30 minutes. However, while talking with delegates I will cover only the short version. Interested delegates may read the note after the conference.

In economics, all figures are estimates. Different sources give different figures. Exactness is not practical. But estimates do give an idea.

I. Indian Economy:

Foreign Direct Investment (FDI) and Import Substitution – both are planned for encouraging more investment, production & hence employment within India. **Import** substitution is a plan from **1950s**. **FDI** really started from **1992** – when Late PM Shri Narsimha Rao & FM Dr. Manmohan Singh started liberalisation of Indian economy. What was the Need for these measures?

I.1. Almost since 1950s we are a **capital starved country**. Hence foreign investment has been a need for India. However, after independence we had fresh memory that – the **Europeans came to India for doing trade with India**. They were welcomed by the then kings. And then the Europeans became kings. East India Company from England was biggest culprit. But there were French, Dutch, Danish and Portuguese also. Hence after 1947 India was very cautious about foreigners coming into India. To prevent foreigners from dominating business in India, the laws used were: Industries (Development & Regulation) Act, 1951 – as guided by **Industrial Policy** and FERA as guided by Foreign Direct Investment **(FDI) policy**.

The Europeans had successfully destroyed Indian manufacturing and India was **importing almost every manufactured product**. And we were **exporting** agricultural products and ores – **low value items**. So we constantly had **trade deficits** every year. Consequently we had **Balance of Payments** problem, scarcity of foreign exchange, constantly **depreciating Rupee** and **constant inflation** in India. External Depreciation of Rupee and internal inflation were feeding each other and we had a vicious cycle damaging Indian economy.

While we had ceased to be a political colony of Britain, we became an economic colony; a Client State for the Western World.

I.2 In this situation, Government adopted following policies:

Since **capital** was scarce, GOI thought of rationing use of capital by strict **Industrial Licensing**. To **discourage import** of goods & services – high customs duties were imposed. For certain products import duties were not enough discouragement. So strict **import licensing** was imposed. Rupee was deliberately depreciated every year. Customs duties became an important source of revenue for GOI. So GOI was happy.

High direct tax rates was another policy. Highest individual income-tax rate was 97.50% for incomes above Rs. 1,00,000 per year. Wealth tax rate was 8% and Estate Duty rate was 85%. It was as if GOI was robbing anyone who earned.

I.3. Sum total of all these policies was-

3.1. There were high **premiums for import licences**. There was a huge black market for import licences.

3.2. Gold and many other items came into India via **smuggling**. Simple items like Japanese polyester cloth was a premium item in the 1960s.

3.3. Indian residents who wanted to go abroad needed RBI permission. They were allowed US $ 8 per trip abroad. There was a huge **black market for foreign exchange** (Fx).

3.4. Anybody who had money, would largely have **black money**. For the sake of safety from income-tax department, he would send money abroad & keep with Tax Haven banks. This boosted **hawala market** for Fx.

3.5 Smuggling and Hawala market fed each other.

I.4. All these factors caused several vicious cycles keeping India poor. Government laws and policies were failures. Instead of reversing the policies, Government after Government went on making the laws harsher & punishment provisions stricter. No foreigners would make new investments in India.

Historically there were some foreign companies like Colgate, Coca Cola, Hindustan Unilever, IBM, etc. They had very large percentage of Indian market. They gave no technologies to India and essentially manufactured low tech commodities. Even IBM simply rented outdated computers in India. **In the year 1978** the then Industries minister **Late Mr. George Fernandes** threw out low tech foreign owned companies (FERA Companies) or forced them to reduce the foreign owned equity to 40%.

Large Indian business houses were happy getting import licences and making huge profits on trading in scarce imported goods. There was hardly any research and innovation. Only things India manufactured were low value commodities like cloth and basic steel.

I.5. Result of these policies was so bad that India was on the **verge of insolvency in the year 1991**. 1947 to 1991 – it took 44 years to prove that GOI & RBI policies were wrong and were causing more damage than benefit.

I.6. Then the duo of PM - Late Mr. Narsimha Rao & FM - Dr. Manmohan Singh started **liberalisation in the year 1992**. Import & Industrial licensing were almost scrapped. Direct & indirect tax rates were brought down. Licence & Control Raj was almost scrapped. These significant policy changes started giving positive results and by the year 2000, India was firmly placed on growth curve.

I.7. Now it seems for the last few years Indian economy is again going down. **Instead of import substitution**, imports of even insignificant items like Diwali decorations etc. have started in a big way. **GOI liberalised import of Chinese products around the year 2010**. It is said that due to the liberalisation made in the year 2010; today so many **industries are dependent upon Chinese products.** When China attacked Indian Territory in Ladakh this year, (June 2020) there was a call for banning Chinese imports. At that time it was realised that so many industries were dependent upon Chinese imports. If all imports were to be banned, some Indian industries would close down. For illustration Indian Pharmaceutical industry is dependent upon Bulk drugs from China. Tirupati ready-made garments industry is dependent on China for import of accessories.

2. Look at China:

China is world's largest exporter ($ 2.5 tri.) and second largest importer ($ 2.1 Tri.). It has world's largest FX reserves ($ 3.8 tri including Hong Kong). Second highest GDP ($ 14 Tri.) in nominal terms. In PPP terms Chinese GDP ($ 28 Tri) is more than US GDP ($ 20 tri.) also. For huge exports, China also imports many raw materials – especially crude oil. Chinese policy is directed towards large exports, creation of huge Fx reserves and dominating the world in economic as well as political terms. Import substitution has no place in Chinese strategy.

Puzzle: Chinese imports including transport cost are found to be cheaper than Indian raw material cost. This makes import substitution impractical. How does China manage to sell at such low prices is a great puzzle.

Clear answer to this puzzle is that China subsidises exports in a very big way. The subsidy is in many ways. **Chinese currency** has been massively **devalued**. In the year 1980 – when Chinese Economic Liberalisation started, exchange rate was – One US $ equal to **1.75 Chinese Yuans**. Today it is $1 = **Yuan 7**. Chinese **wages** are far lower than wages in other comparable countries. Exports are hugely given **cash subsidies**. So even if they make losses as difference between cost of purchase & sales revenue; **their losses are made good by Government**. China also adopted a policy of massive industrialization – mechanization; and **very large size factories**. Whole industrial policy is tuned to massive exports at very low prices. And they give reasonably good quality. It is alleged by US Government & industry captains that Chinese people steal so may technologies in complete disregard for **intellectual property rights.**

As a result China became second largest economy in the world and has The Largest Foreign Exchange reserves – $ 3.8 trillion (China & Hong Kong both included). It has annual trade surplus above US $ 400 Bn. In the year 1980, the trade deficit was $ 2 Bn.

Problems:

However, note that all the subsidies given to the whole world have to be borne by someone. That someone is Chinese economy. As a result, China has huge FX surplus and at the same time, huge internal debt. It is said that China's gross total debt would be more than 3 times its GDP.

A part of the losses are suffered by:

(i) the workers who get **low wages** – as compared to wages in comparable countries;

(ii) **Domestic Suppliers** of agricultural products, ores and other raw materials in terms of low sales realisation. This has twists & turns. The suppliers get adequate remuneration in terms of Chinese currency. Currency is low valued. Difference between a fair price of the currency –Purchasing Power Parity & market price is **ultimately borne by Chinese Government.**

(iii) Cost of all **cash subsidies** – whether declared or hidden is also borne by the Government.

All these costs together have made China having huge total debt.

Advantages:

Huge & continuous trade surpluses have enabled China to be world's large importer of goods. This power to purchase large quantities has **silenced many critics of Chinese apartheid** within Chinese Muslim communities.

Huge Fx reserves have enabled China to **give loans to tottering European countries**. This was unimaginable in 1980. Europe was still rich. China was very poor. Now the tables got reversed. Even **Russia** – which was Big Brother to China (both communist countries); now has to respect Chinese military.

China has not followed Import Substitution. But China is world's second largest importer. But she exports more than she imports. That is the key.

China has made it impractical for many countries to substitute imports by domestic production. This is deliberate strategy adopted by China. China wants to dominate the world by economy and politics. India has fallen for Chinese low cost imports.

China with **300% of GDP as its internal debt** is in difficult position. Now **US has started trade war with China**. There were veiled threats that **USA may cancel her debt to China**. That would mean global disaster. Global financial systems will be jolted. But for China it could be a real disaster. China knows this. She wants to replace her $ 3 trillions of US assets. It is not easy. China cannot buy gold because that much gold simply is not available in the market. China is spending huge money on One Belt One Road and similar projects – outside china & outside USA.

3. USA: Now consider US policies.

USA had a deliberate policy of outsourcing production of goods. Hold intellectual property rights, **control global marketing** and ensure that maximum profits are in marketing & not in purchase or production functions. USA has also ensured that **US $ remains global currency** for trade, investment & even speculation. Having $ as global currency has enabled USA to borrow trillions of Dollars at zero interest cost. It is said that today the only things that USA exports are: US $ and weapons. Everything else is manufactured by others & imported by USA. Of course this is an exaggeration. But it does indicate that in USA, **Import Substitution has gone for a Big Toss. And yet, USA is the beneficiary.**

There are some fundamental principles. Like Truth & Love. **Import substitution is not so fundamental**. USA is world's largest importer of goods & services. This was a deliberately adopted strategy by US Government & business lobbies. It was late Mr. Jack Welch – chairman of General Electric who started & canvassed for outsourcing manufacturing to China. Globalisation was the key word in 1980s to 2007.

USA ensures that suppliers to USA devalue their currencies. When the same countries start competing with US industries, they are pushed to revalue their currencies. One can write a whole book on US economic policies. But the purpose of this note is to high light that **Import Substitution and FDI are not necessarily panacea by themselves.**

With these policies and for several other reasons, USA today is in serious difficulty. Since manufacturing was outsourced, there have been huge job losses, falling standards of living in the rust belt. US economy has become dependent on Chinese imports.

Now present government wants to change the policies. With In-shoring – will US be able to bring back the jobs? Cost of imported goods & services will increase. US has $ 26 trillion in debt. It is expected that Covid relief package will cost about $ 4 tri. on top of a regular budget of $.4.4 trillion. USA has no capacity to repay its debts. Fiscal Cliff – Budgetary deficits beyond legally permissible limits is not a problem now because it seems the law has been scrapped. For the year 2020, US Federal budget will be – Regular expenses $ 4.8 tri +Covid relief package $ 4 tri = $ 8.8 tri. Planned budgetary deficit of $ 1.1 tri will increase to $ 5.1 tri.

World experts in economics and even governments are losing its faith in $. If world stops accepting $ for its global trade & investment; US will lose its continuous borrowing from the world. Then she will not be able to maintain its army and navy all over the world. China is ready & eager to move into any area that US vacates. US is slipping into deeper difficulties. What is her response? Is USA trying to conserve resources, to acquire ability to control expenses and repay debts? No. US is spending even more money.

From the year 2000 China has realised that US economy is not safe, holding of US $ & treasury bonds is not a prudent economic policy. China struggled to reduce her dependence on USA. China knows the dangers of holding on US $. It has started spending $ in a big way in several countries around the world; and increasing Chinese dominance in the world. Now both nations (USA & China) are at an Economic War. Now USA wants to decouple from China. But finds it difficult.

Many experts in the world realised by the year 2000 the same message. Decoupling from USA was the buzzword in financial circles. But world has not been able to decouple from USA or China.

Present government wants to change past policies and decouple US economy from Chinese economy. It is not easy. US Government has realised this fact with bitter experience. Indian economy is as yet, not so much dependent on China. We should better become independent of China at the earliest.

IV. Let us now come back to India.

Where do we, Indians stand in this global situation?

In import of **crude oil**, India has tried its best. **We just cannot be independent**. India is 3rd largest buyer of crude oil. Our major import is crude oil. GOI is using buying power as leverage in political matters also. Saudi Arabia, UAE & Organisation of Islamic Countries (OIC) are now friendlier to India than to Pakistan. For many decades Pakistan used religion as a binding factor with OIC. Now Pakistan has no money to buy even its annual requirement of crude oil. So religion has become a secondary factor. Pakistan is losing its influence globally.

In Terms of Trade, foreign exchange conversion rate plays a very important role. But India has consistently followed a practice of depreciating Indian Rupee. This has caused massive losses to Indian economy. I have written separate paper on this subject. **US $ has depreciated globally by about 10% in the current year**. This may be because of US government's plan to spend $ 4.2 trillion on Covid relief package. (Compare with the Federal Budget of $ 4.4 trillion in the Calendar year 2019.) Or that world is now not so sure about stability of US Dollar. Or it may be US government's strategy to make imports costly, boost local sales & win elections. However, **Indian Rupee has not appreciated by 10% against US $. Why?** Because RBI buys $ in the market & does not allow Rupee to appreciate. Result is an increase in Fx reserves. But let us be clear that Indian FX reserves have not been built by surplus of exports over imports. These reserves are built largely by RBI purchases to prevent Rupee appreciation.

Today Buying Power is a big tool in the hands of governments. Mr. Trump also behaves nicely with India – as compared to several other countries because of – (i) voting power of NRIs in USA and (ii) India's large orders for US weapons etc. Pakistan is becoming somewhat irrelevant for USA.

Late Prime Minister Shri Vajpayee permitted nuclear explosion "Buddha Smiles" in the year 1998. US imposed sanctions hoping that India will plead to remove the sanctions. India never made slightest request for lifting sanctions. US realised that India can live & grow without USA. Finally, US took the lead to lift the sanctions, to make India a member of the Nuclear Club. All because USA needed Indian market.

Has Government & RBI policies succeeded in preserving the value of Rupee? Answer lies in plain facts. In the year 1947 Indian rupee was – Rs. 4 = US $ 1. Today Rupee has depreciated to Rs. 74 = US $ 1 and $ has depreciated significantly. More direct comparison is with gold price. Gold price for 10 gm in 1947 was Rs. 88. In 2020 it is Rs. 52,000. **Rupee has depreciated to 0.16% of its value** or one upon 600.

As discussed earlier, from 1947 to 1992 India had tremendous scarcity of Foreign exchange. Biggest victim of the scarcity psychology is RBI. It has still not come out of the 1991 psychology. Even today it is administering FEMA and managing external value of Rupee with the same fear psychosis.

It is totally incorrect to say that **Singapore & Mauritius** are important sources of FDI. They are both tax havens. They are just places to register SPVs and do treaty shopping to enjoy undue tax benefits. Real investment is coming from other countries. One estimate is that Round Tripping of Indian money back into the country is significantly high. Point is – Singapore & Mauritius cause harm to Indian economy, not benefit to Indian economy.

Bureaucracy generally damages FDI. It cannot encourage FDI. Explanation: India had a mindset that foreign investment & NRI investments are harmful for the country. Hence these were prevented through FERA & Industrial Licensing. These laws were enforced by (i) RBI & Department of Enforcement DOE (ii) DPIIT and its predecessors in Central Government ministries. Only way a government knows to **enforce the law is by Fear** and more fear. If law does not work, make the law stricter; give more & more powers of punishment to the law enforcers.

Then Government changed its policy. FDI & NRI suddenly became welcome. Prime Ministers & Finance Ministers would go around the world appealing captains of industry to invest in India. When the foreigners come to India, they face Indian bureaucracy. It is the same bureaucracy which was preventing FDI. It has a mindset. Many officers have still not come out of their **Pre-1992 Mindset & culture of control.** Consider an illustration. There is a police chowky. They are accustomed to using lathi & guns to enforce the law. Suddenly in the year 1992 Government decided that the same policemen should now teach the Kindergarten children. What would happen? I can give innumerable illustrations of how RBI & Income-tax department have frustrated FDI & NRI investments.

Desire to purchase is not sufficient. Pakistan wants to buy weapons, crude oil and a lot. But has no money to pay. Now Saudi Arabia, UAE & other Muslim countries are avoiding Pakistan. India has capacity to buy crude oil when global demand for crude has collapsed. So fundamentalist Muslim countries are being friendly with India. **Economy is being used for politics. And political games – trade wars are being fought for economics. Everything is mixed. And everything keeps changing.**

Some imports can never be substituted. For example, Crude Oil and Gold are simply not there in Indian oil wells & mines. We need to import them. Hence we also need to develop exports for being able to import. At Government level all issues need to be considered together. They simply cannot – like economists assume – “All other things remaining constant”. Reality is – all things keep changing. All things interact & affect all other things. There are processes and vicious as well as virtuous cycles. And the cycles reverse themselves. In these circumstances Government has to manage national economies, politics & so many other issues.

V. FDI. Some issues about FDI.

One benefit of FDI was that in the years following 1992 IMF and foreign investors demanded removal of licence & control raj. GOI listened to foreigners. And import licensing as well as industrial licensing are almost scrapped. FERA is liberalised into FEMA. Importance of FDI lies in being a catalyst to liberalise Indian economy. The scrapping of "Licence & Control Raj" gave a boost to the Indian Entrepreneur spirit. Indian GDP grew from $ 266 Bn in 1991-92 to $ 3 trillion in 2019-20. FX reserves grew from the Nadir of $ 1 Bn in 1991 to $ 540 Bn today. Please note, this growth is mainly due to Indian domestic business & industry. FDI's role is much less significant. This statement may seem to be contrary to popular belief. Let me explain.

Let us look at the size of FDI & compare with domestic investment. During the year 2019-20, total FDI was $ 49 Bn. **Total FDI for twenty years** from April 2000 to March 2020 was $ 615 Bn.

Indian GDP in the year 2019-20 was $ 3 trillion. Savings rate was 30% of GDP. Thus **domestic savings were $ 900 Bn**. In a single year. Actual capital formation during the year 2019-20 was $ 615 Bn. (this is total of Domestic Investment & FDI.)What is more important – Domestic investment or FDI? Why do we run after $ 49 Bn of FDI?

I am not saying – "Do not attract FDI + NRI." Attract them. FDI is useful. NRI investment has been our life saving source – Economy saving source. But give more emphasis to Domestic investment & business. Do not treat domestic businessmen as Government's enemies. Do not pre judge them as "Guilty". Encourage the wealth creators.

On 15 Aug, standing on the Red Fort ramparts, Prime Minister Narendra Modi reiterated his government's **economic vision of self-sufficiency**, adding that **India would aim to become the supplier to the world**. Let us hope, the RBI, the bureaucracy and all help in realisation of this dream.

Conclusion:

In economics nothing is simple. Why?

Because today's economics & politics are games of greed and ego. There is no spirituality. No sense of fairness. God has so designed this Sansar that the sources of greed & ego satisfaction will keep changing. So relations built on greed and ego will also keep changing until they collapse.

This conference is on Import substitution & FDI. These are part of economics. Law compliance is secondary at national & global levels. If a practitioner studies law in depth and at the same time keeps the macro picture in mind, he can give more useful advice to his clients.

World economy will always be in struggles. There will be challenges and opportunities. People tempted by Maya will try to take short cuts, to exploit others, to start wars when the targets for exploitation resist. Spiritually evolved people will always look for Win-Win situations. When such situations are not available, an evolved person will himself sacrifice. He will never think of exploiting others. In current times, we cannot expect this from our politicians. Hence politicians must be kept under check. Their powers must be restricted by constitution and by Courts. This requires powerful democracy and democratic institutions. Let us hope that vibrant & dynamic democracies prevail in all countries on earth.

Pranam.

Rashmin Chandulal Sanghvi