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INFLOW OF CAPITAL

Foreign Capital and Foreign Aid

29.1 INTRODUCTION

We are quite familiar with the names of some of the rich countries such as the U.S.A, Canada, France, Japan, Hong Kong, Singapore etc. We know that people in these countries enjoy decent living standards. However, only about 1/4th of the total world population lives in the advanced or developed countries. The other 3/4th of world population lives in poverty in the backward countries of Asia, Africa and South America. India, Pakistan, Bangladesh, Ethiopia etc. are the examples of such backward or underdeveloped countries where poverty, illiteracy and malnutrition are widespread. The problem before the underdeveloped countries is, thus, how to improve living standards of their masses. Poor people in these countries need to be provided with more employment, incomes and output for improving their consumption standards. In other words, these economies must be developed.

In an earlier lesson, you have learnt the meaning of economic development. You have also studied, that apart from other factors, capital plays the most significant role in economic development of underdeveloped countries. But shortage of capital is a common feature of these poor nations. The problem, therefore, is to have more capital. This capital can be gathered from internal sources such as country's own savings or it could be raised from external sources such as loans and grants from foreign countries or in the form of investments in this country by the foreign nationals. This lesson deals with these external sources of capital, i.e., inflow of capital into a country from other countries or international institutions.

29.2 OBJECTIVES

After going through this lesson, you will be able to:

- explain the role of capital in the process of economic development;
- identify the internal and external sources of capital;
- explain the need for foreign capital in a country's economic development;

- list the main forms of inflow of foreign capital and importance of each type of inflow;
- explain the role of various types of foreign capital inflows in the development process of the Indian economy.

29.3 INTERNAL SOURCES OF CAPITAL

Internally capital formation takes place when a country does not spend all its current incor on consumption, but saves a part of it and uses it for investment for increasing furt' production. The twin act of saving and investment is described as **capital accumulation** or **capital formation**.

Saving of a nation is the sum total of savings made by its various economic units. In India, we classify these economic units as (i) households, which consists of individuals and non-profit organisations such as schools, hospitals etc.; (ii) private corporate sector which covers big business units organised as companies; and (iii) public sector comprising government departments and government enterprises. Most of the savings in India (about 80%) come from the household sector. The contribution of private corporate sector is about 15 percent while that of public sector is insignificant and sometimes negative.

Saving rate has been very low (about 10% of the national income) in the early years after Independence. It has now gone up to about 25 percent in recent years. However, most of the underdeveloped countries still have extremely low domestic saving rates and therefore, are in need of large inflow of capital from external sources to finance their development programmes.

29.4 FOREIGN CAPITAL

(a) Meaning:

Capital, in financial sense, refers to those funds which are used for investment. In physical sense, capital means all capital equipment, plant, machinery etc. which is used in production process. Thus finances are to be raised through savings and used for buildings, plants and equipments for use in production. In other words, savings and investments are the two acts which create capital.

When residents of a country provide their savings for investments, this capital is called **domestic capital** and owned by residents. But when investment is made either directly by the non-residents, institutions or governments, this is called **foreign capital** and owned by non-residents. Thus, for example, Campa Cola factory represents domestic capital whereas Coca Cola represents foreign capital. The non-residents may provide funds for investments by way of equity, loans, grants or make direct investment. All of these are the various ways in which foreign capital may flow into a country.

(b) Need for Foreign Capital:

Foreign capital is that part of investments in a country whose ownership belongs to the non-residents. It is, in essence, savings of the foreign countries which has been used by a country for its investment projects. Foreign capital plays a significant role in financing development process in the underdeveloped countries. The less developed countries suffer from many handicaps such as extremely low saving rate, backward technology, shortage of foreign exchange etc. These handicaps must be removed if the country wants to make progress. Foreign capital helps in overcoming these handicaps by providing investment funds, modern technology and foreign exchange resources. Here, we discuss three broad gaps which foreign capital helps to fill up and this speed up the development process.

(i) Saving Gap :

The underdeveloped countries have extremely low incomes and are thus not able to save much for investment. But economic development requires that the rate of investment must be stepped up and maintained at a higher level. If more savings are not made available, investment would remain low and progress cannot be made. Since domestic savings are low, foreign capital (which is foreign savings) can fill the gap. Foreign capital, thus supplements domestic capital supply and helps in financing programmes for economic development.

(ii) Foreign Exchange Gap :

The underdeveloped countries need capital equipments and other materials for economic development. Most of such machinery, equipments and other necessary materials are not produced in these countries. These must, therefore, be imported from advanced countries. But payments for imports require foreign exchange, which can be earned only from exports. Since exports of the less developed countries are small, the amount of foreign exchange earned is not sufficient to pay for increasing imports. Foreign exchange must somehow be made available because otherwise imports of machinery and equipments cannot be made. Foreign capital fills this gap between the required amount of foreign exchange and its available amount, and thus helps in speeding up the development process.

(iii) Technology Gap :

The underdeveloped countries suffer from technological backwardness. The production methods in these countries are outdated and the equipment used is obsolete. Economic development requires that this old technology must be replaced by modern technology. For this modern sophisticated equipment needs to be imported from advanced countries. Services of foreign engineers and technicians are required to install this new equipment and impart knowledge of these new techniques to the local people. Imports of modern machinery and use of services of foreign experts in all the various aspects of business, whether it is production, management, sales, research, training etc., enable the nation to become technologically strong. Foreign capital enables import of this sophisticated technology and helps to acquire services of experts in various fields, without which country cannot make rapid progress. Thus, foreign capital fills the technology gap, the gap between required modern technology and the domestically available backward technology.

POINTS TO REMEMBER

- Foreign capital means investments made by non-resident institutions.
- It supplements domestic capital supply.
- It fills the gap between the required amount of foreign exchange and the amount available.
- It fills the gap between modern technology and backward technology.

INTEXT QUESTION 29.1

State whether the following statements are True (T) or False (F):

(i) Underdeveloped countries need to step-up their investment rates to bring about economic development.

(ii) Underdeveloped countries can supplement their domestic saving with inflow of foreign capital.

(iii) Foreign capital also fills up the foreign exchange gap.

(iv) No country has ever used foreign capital for its development.

(v) Foreign capital represents use of savings of non-residents by a country.

29.5 FORMS OF EXTERNAL CAPITAL

The two main forms of capital inflow from external sources are (i) Foreign Direct Investment (FDI), which is also known as **private foreign capital**, and (ii) International loans and grants, also known as **foreign aid** or **external assistance**. Another source of capital inflow is commercial borrowings, i.e., borrowing from foreign banks, investment trusts and commercial institutions. However, the role of commercial borrowings is still very limited.

29.6 FOREIGN DIRECT INVESTMENT

Foreign Direct Investment (FDI) or private foreign capital includes all investments made by foreign companies, firms and individuals in various sectors of the economy. The primary aim of such investments is to earn profits and therefore, its inflow is towards those activities, which offer largest profitable opportunities. Most of such investments are made by big foreign companies by setting up their branches and offices in underdeveloped countries. These big foreign companies which have a vast network of investments in various countries are called **Multi National Corporations** (MNC's). Some of the quite familiar names such as Pepsi-Cola, Coca-Cola, etc. are all MNC's now operating in India.

(a) Advantages of Foreign Direct Investment (FDI)

Some of the advantages of FDI are as follows:

(i) It supplements domestic investment:

FDI makes total investment larger than what could be possible through domestic savings only. Larger investment, in turn, enables a country to achieve a faster rate of economic growth.

(ii) FDI does not pose any problems on the balance of payments:

The foreign investors bring in their own equipment and machinery. There is, thus, no increase in import bill and no strain on balance of payments.

(iii) FDI does not give rise to problems which are associated with the repayment of international loans:

Since FDI is an investment made by the foreigners directly and voluntarily, it does not pose such problems as repayment of the principal and the interest on foreign loans. Hence, FDI does not give rise to foreign exchange problems. The only payment involved is the sending of profits to the foreign country. But here, the FDI can help by increasing production and exports and thus earning enough foreign exchange to provide for repatriation of profits.

(iv) FDI helps in adoption of modern technology and efficient management techniques:

The foreign investors not only set up new factories but also bring in their own engineers, technicians and management people. The local people working with these experts can gain new knowledge or get training under them and use this acquired knowledge and techniques for various other activities.

(b) Disadvantages of Foreign Direct Investment (FDI)

While FDI is believed to play a positive role in economic development of the underdeveloped countries, actual experience of India in the pre-Independence days shows that this has been an obstacle to our progress. Some of the disadvantages or drawbacks of FDI are as follows:

(i) FDI instead of supplementing domestic capital more often serves to destroy domestic enterprises and hamper development:

As domestic industry most often fails to face competition from international industrial giants, this inevitably results in their closure and the consequent permanent dependence of the country on foreign enterprises.

(ii) The argument that FDI helps in modernisation of technology is also not correct:

Most of the foreign companies keep their technology closely guarded secrets. Local people do not get much chance to learn from them.

(iii) The argument that FDI does not create balance of payment problems is also not correct:

It is true that initially there is no pressure, but in course of time pressure builds up on the BOP as these companies transfer huge amounts by way of profits, royalties, management fee and import substantial quantities of costly spare parts and maintenance equipment.

(iv) FDI flows into those industries which offer high profits even when those industries are on the low priority list of the country:

Before Independence most of foreign investment in India went into jute industry and tea gardens (which were more profitable as they were sold in foreign markets), whereas steel, cement and other heavy industries needed by the country remained neglected.

POINTS TO REMEMBER

- The two forms of foreign capital are : (i) Foreign direct investment (FDI) and (ii) International loans and grants.
- FDI has many advantages : (i) Supplements domestic investment, (ii) does not put any strain on balance of payments; (iii) No problem with repayment of international loans; and (iv) Helps in adoption of modern technology.

INTEXT QUESTIONS 29.2

State whether the following statements are true or false :

(i) Inflow of foreign capital comes by way of foreign direct investment and international loans and grants.

(ii) Foreign direct investment means that foreign financial institutions purchase shares of the existing Indian companies.

(iii) Foreign capital and foreign aid can both be made use of in the development process.

(iv) Multi-national corporation are small companies which can have no influences on the economy.

29.7 FOREIGN AID OR EXTERNAL ASSISTANCE

Another form of capital inflow is foreign aid. Foreign aid refers to those foreign funds that flow into a country by way of international loans and grants. These loans and grants are generally given by foreign governments or some international agencies like the World Bank to various countries for financing their development programmes. While grants are, non-returnable, the loans have to be paid back over a specified period of time. Thus while grants are by nature a kind of aid given by the foreign governments or agencies, loans are called aid only when (i) they have concessional terms viz. low rate of interest and long repayment period which is convenient to the borrowing country; and (ii) the objective of these loans is non-commercial i.e. the loan giving country does not have the motive to earn profits by granting these loans. However, all military aid is generally excluded from the definition of foreign aid.

(a) Bilateral and Multi-lateral Aid:

Bilateral aid refers to the aid given by one country to another. There are thus only two parties involved in this viz. the aid giver and the aid receiver. The U.S. aid to India is thus an example of bilateral aid.

Multi-lateral aid means when many countries together pool their funds to give aid to one country. Thus aid received by India from Aid India Consortium, now renamed as India Development Forum - which is an association of many countries who provide aid to India through this forum is an example of multi-lateral aid.

Aid from international agencies like the World Bank, International Development Association, Asian Development Bank etc. is called institutional aid. This can also be regarded as multilateral aid because these agencies have been set up by a joint action of many countries who contribute to the funds of these agencies.

(b) Untied and Tied Aid:

Untied aid or free aid is one where the aid receiving country had freedom to use this aid on whatever project it wants to use. The country has also the freedom to spend the aid funds to buy equipments and materials for these project from whichever country it desires.

However, when conditions are laid by the aid giving country that funds given by it can be used only for some specific projects and not elsewhere, it is called **tied aid**. In this case aid can be used only for the projects agreed to in the aid agreement and hence it is called **project tied aid**.

When a country gives aid and also specifies the sources or countries from where materials can be purchased with these aid funds, it is called **source tied or country tied aid**. In this case the aid receiving nation is not free to spend funds on imports of materials from countries which it may feel better, but can do so only on sources or countries that have been prescribed in the aid agreement..

(c) Advantages and disadvantages of Foreign Aid:

When aid is free or untied, it confers a distinct advantage on the aid receiving country. Such foreign aid (loans and grants) can be used by aid receiving countries for projects and programmes that fit into its own priorities.

However, as said earlier, most of the aid these days is not untied so as to give that necessary freedom of use. Foreign aid today is largely tied to the specific projects as well as to the markets of the aid giving countries. Tied aid restricts the freedom of aid use, i.e., the aid receiving country cannot use aid for the projects it deems to be of high priority as it can be used only for the projects for which aid has been specifically given. And when aid is tied to the country which gives aid, it means all equipments and materials are to be purchased from that country only. For example, when USA gives tied aid to India, this country has to purchase US goods only. If prices of these goods are, say, double of the prices prevailing in Japan, then compulsion of buying from USA would only get India half the amount of goods with these aid funds compared to what India could buy from Japan. Thus, aid tying reduces the real value of aid.

Besides problems associated with tied-aid, an important drawback of foreign aid is that it imposes high burden of debt servicing on the aid receiving country. Debt-servicing includes repayment of installments of debt and the interest due on that debt. In course of time, this amount of debt servicing payments rises and consumes substantial amount of foreign exchange earnings of the country. For example, in 1991, over one-third of India receipts on current account (receipts from exports of goods and services) was being used for debt servicing. Even now, over a quarter of the current account receipts go to meet our debt-servicing payments.

Continued borrowings increase a country's international debt. A time comes when every time a new loan has to be raised to pay off the interest and installments of the earlier loans. This situation where a country has to raise a new loan to pay off the earlier loan, is called **debt-trap**. This is an alarming situation where a country may lose its credit-worthiness which, in turn, would adversely affect inflow of foreign capital.

29.8 FOREIGN AID RECEIVED BY INDIA

Authorisation and Utilisation

The quantum of foreign aid received by a country is expressed in two ways viz. (i) authorisation and (ii) utilisation. **Authorisation** means the amount of aid which foreign countries and international institutions agree to provide to a country. This is the quantity of aid sanctioned or committed by the aid giving countries and institutions. **Utilisation of aid**, on the other hand, represents the quantity of foreign aid that has actually been made use of by the aid receiving country. When other nations grant or authorise aid they do not give all the amount at one time. Aid is released in installments over a time period subject to various conditions such as launching of the projects, the various stages of their completion etc. The gap between the authorised and utilised aid is called **undisbursed aid** or aid in the pipeline.

The total amount of external assistance authorised to India since Independence till the end of March, 1996 amounted to Rs. 1,60,481 crores. Of this, 89 per cent was in the form of loans and the remaining 11 percent comprised grants. Largest part of aid came from the World Bank (IBRD) and International Development Association (IDA). Among the countries, Japan provided largest amount of aid to India. Detailed source-wise assistance is shown in table 29.1. Utilisation of aid since Independence till end of March, 1996 was Rs. 1,16,652 crores, which was only about 73 per cent of the total authorised aid.

Table 29.1

Aggregate External Assistance Received by India (upto end of March, 1996)

Country/ Institution	Authorisation		Utilisation	
	Amount Rs. Crores	%age of Total	Amount Rs. Crores	%age of Total
IBRD	35568	22.2	27002	23.2
IDA	33389	20.8	28020	24.0
ADB	12717	7.9	7169	6.1
Germany	8247	5.1	7836	6.7
Japan	25793	16.1	16234	13.9
USA	6966	4.3	6730	5.8
USSR (CIS)	14029	8.7	2716	2.3
U.K.	6217	3.9	5305	4.6
Canada	2040	1.3	1413	1.2
France	2985	1.9	2939	2.5
OPEC	2078	1.3	1894	1.6
Others	10452	6.5	9392	8.1
Total	160481	100.0	116652	100.0

Source: RBI Report on Currency and Finance, 1995-96, Vol.II, P.263.

29.9 ROLE OF FOREIGN AID IN INDIA'S ECONOMIC DEVELOPMENT

Foreign aid has played an important role in planned economic development of India. It has filled in the gap arising out of scarcity of domestic savings to finance the five year plans, thus helping the country to achieve the plan targets. Whereas only a small amount of Rs. 190 crores of foreign aid was used in the First Plan, its quantum increased manifold during the successive plans to reach the level of Rs. 28,700 crores in the Eighth Plan. This enable the country to make larger investments.

Much of the foreign aid inflow has been used for industrial development. Foreign aid has helped the country to build up the big steel plants, and such vital industries as heavy electrical, transport equipment and telecommunications. It has also played a significant role in the development of other industries like coal, fertilizers, automobiles etc..

Progress of agriculture owes much to foreign aid that has been made use of building as the irrigation projects and modernising farming techniques. More important than all these is the role played by foreign aid in improving our technology through imports of most modern and highly sophisticated machinery. Foreign engineers, technicians, management personnel that have been visiting India under aid programmes have done a lot to improve our knowledge and work methods.

But foreign aid has not been an unmixed blessing. It has created many problems for the country as well. Aid inflow has been often uneven and erratic thus giving rise to uncertainty and the consequent slow pace of progress. It has also caused much dependence of our country on foreign aid. Above all, India is now facing problems of repayment of loans and interest on them as country's external debt goes on mounting.

29.10 INDIA'S EXTERNAL DEBT

Due to continued international borrowings to finance domestic activities, India's external debt, which stood at about $ 75 billion (Rs. 1,30,199 crores) at the end of March, 1990, shot up to $ 99 billion (Rs. 3,11,792 crores) in March, 1995. It, however, came down to $ 92 billion (Rs. 3,15,435 crores) in March, 1996. India's external debt position is shown in the following table 29.2:

Table 29.2 India's External Debt (As at the end of March)

Crores US Dollars

	1994	1995	1996
Long term debt	8906.8	7473.9	8715.9
Short term debt	362.7	425.9	503.4
Total debt	9269.5	9900.8	9219.3
Short term debt as a %age of GDP	3.9	4.3	5.5
Debt-GDP Ratio	36.9	33.0	28.9
Debt-Servicing Ratio	26.7	27.5	26.4

Source: RBI Report on Currency and Finance, 1995-96, Vol.I, PP.X-31.

The real impact of debt on a country's economy and its international credit-worthiness is measured by the debt-GDP ratio. A debt-GDP ratio of over 30 per cent is taken to indicate that the country is slipping into an **international debt-trap**. In fact, India had moved into this debt-trap when the debt-GDP ratio jumped from 30.4 per cent in 1990-91 to 41.0 percent in 1991-92. However, there has been a substantial reduction in our debt-GDP ratio in recent years as this came down from the peak level of 1991-92 to about 29 per cent in 1995-96. Though India is now out of the debt-trap, yet it still remains dangerously close to it. Among the other countries caught in this debt-trap are Mexico, Thailand, Phillippines, Indonesia and Malaysia.

29.11 GOVERNMENTS POLICY TOWARDS FOREIGN CAPITAL

Mounting external debt and constant threat of slipping into international debt-trap has become a serious problem. The Government of India announced its new Industrial Policy in July, 1991. A clear cut shift of government policy from foreign aid to foreign direct investment is quite visible in this policy. In the earlier policy towards foreign capital, direct foreign investment was allowed only in a limited number of industries. In addition, there was a condition that Indians will have a major share in their capital and control over their decisions. The new policy now allows majority participation by foreign investors in a large number of industries. FDI is being invited into key sectors such as power generation, communication etc. Initially 34 high priority industrial sectors were identified for majority participation by the foreigners. This list has now been expanded and limit of foreign equity participation has been increased from 51 per cent to 74 percent in many industries. Consequent to this new liberal policy, flow of FDI has improved. Whereas in 1991 amount of foreign investment approval by the government amounted to only Rs. 535 crores, it went upto Rs.3888 crores in the next year and further shot up to Rs. 30,882 crores in 1995. In dollar terms, inflow of foreign investment increased from \$0.4 billion in 1992-93 to \$ 4.9 billion in 1994-95. With many more concessions now being given, India expects this inflow of capital to reach \$10 billion annually.

POINTS TO REMEMBER

- Foreign aid refers to funds flowing in the country by way of international loans and grants from foreign governments, World Bank etc.
- Bilateral aid refers to the aid given by one country to another.
- Multilateral aid means when many countries together pool funds to give aid to one country.
- Foreign aid fills gap arising out of scarcity of domestic savings.

INTEXT QUESTIONS 29.3

State whether the following statements are True (T) or False (F):

(i) International loans to a country given on concessional terms are called foreign aid.

(ii) Loans give a country greater freedom in their use than the foreign direct investment.

(iii) A country can raise unlimited amount of foreign loans as they do not create any problem in their repayment.

(iv) Tied aid is preferred to untied aid for development of underdeveloped countries.

(v) International debt-trap is a situation where a country has to raise a fresh loan to pay for servicing of the loans raised in the past.

WHAT YOU HAVE LEARNT

The underdeveloped countries need large quantities of capital for achieving rapid economic development. Domestic savings in these countries are very low. Hence, they need capital from foreign countries and international institutions. Foreign capital flows into a country either by way of (i) direct foreign investment or (ii) international loans and grants also known as foreign aid. Foreign direct investment supplements the domestic investment. It does not create balance of payments difficulties and helps in adoption of modern technology. But such capital which comes through multinational corporation creates some problems for the country. Foreign companies give stiff competition to domestic producers and often destroy them. Foreign investments cause drain of resources as payment has to be made for royalties, profits, fee etc. to the foreign countries. Foreign companies often discriminate between locals and foreigners and do not impart their knowledge to them. Therefore, external aid becomes a preferred source of capital inflow as it could be used by a country according to its own priorities. But foreign aid is often tied to specific projects and markets and hence its use becomes restricted.

Continued indiscriminate borrowings leads to mounting external debt. This makes the debt servicing ratio to go up very high so as to lead a country into debt-trap. The country has, thus, now sought to reduce the foreign borrowings and invite more of direct investment. The new industrial policy of the July, 1991 has given many concessions to foreign investors, offered them majority participation in many industries and thrown open many new sectors to foreign direct investment. With these liberal measures, the inflow of FDI has gone up substantially.

TERMINAL EXERCISE

1. Briefly describe the need for external capital inflows. What are the major external sources of capital inflow?
2. Explain the meaning of Foreign Direct Investment. What are the benefits of such investment to an underdeveloped economy?
3. Explain the ill effects of Foreign Direct Investment in less developed countries.
4. What is Foreign Aid? What are the essential characteristics of Foreign Aid?
5. How Foreign Aid is more useful than Foreign Direct Investment in the development process of a country?
6. Distinguish between bilateral and multilateral aid by giving suitable examples.
7. What is Tied Aid? What are the problems faced by a country that receives tied aid?
8. What is international debt-trap? What should be done to avoid falling into this trap?
9. Discuss the role of foreign aid in the economic development of underdeveloped countries.

ANSWERS

Intext Questions 29.1

(i) True (ii) True (iii) True (iv) False (v) True

Intext Questions 29.2

(i) True (ii) False (iii) True (iv) False

Intext Questions 29.3

(i) True (ii) True (iii) False (iv) False (v) True

Terminal Exercise

1. Read section 29.4 & 29.5
2. Read section 29.6(a)
3. Read section 29.6(b)
4. Read section 29.7
5. Read section 29.7(c)
6. Read section 29.7(a)
7. Read section 29.7(b)
8. Read section 29.10
9. Read section 29.9