ABSTRACT

As a part of *structural adjustment* program being implemented in India from 1991, foreign capital has been provided greater freedom of entry and operation in the domestic economy through changes in industrial policy and capital account liberalization. The object of this study is to examine the effect of foreign investment inflow on domestic macroeconomic management and its effects on the growth and competitiveness of domestic firms.

The increase in foreign investment inflows between 1991-99 consequent to liberalization, however, did not lead to a higher current account deficit for the economy, implying that net resource transfer did not increase *pari passu* with increased capital inflows. The Reserve Bank of India intervened in the foreign exchange market as a net buyer of foreign exchange to prevent a nominal appreciation of the rupee, accumulating foreign exchange reserves in the process.

Volatility in foreign capital flows, particularly portfolio flows by FIIs, along with speculative transactions by domestic agents [like exporters/importers and domestic banks], influenced the movement of rupee in the foreign exchange market. While during periods of excess supply conditions in the foreign exchange market, direct RBI intervention [as a buyer of foreign exchange] successfully prevented nominal appreciation of the rupee, during periods of excess demand for foreign currency, direct RBI intervention [as a seller of foreign exchange] was unable to check a slide in the value of the rupee. RBI, therefore, had to tighten domestic monetary conditions and raise interest rates - undermining not only its own monetary policy guidelines but perhaps more importantly its ability to nudge the economy onto a low interest rate regime.

RBI's policy of foreign exchange reserve accumulation led to expansionary pressure on domestic monetary aggregates. RBI's attempted sterilization, through open market operations, was not fully successful and domestic liquidity conditions varied with the ebb and flow of foreign finance. Moreover long-term interest rates in the economy, relative to lending rates in developed economies, continued to remain high during the 1990s. An important link between the RBI and the domestic financial system was the former's financing of the government budget deficit. Financial market reform imposed strict limits on such monetization affecting the growth in RBI's net domestic assets. However, given that government's overall credit requirement remained unaltered, financing them meant borrowing from the commercial banking sector - which implied a reduction in availability of banking credit for the non-financial sector. In addition, discontinuance of Reserve Bank credit support to Development Financial Institutions undermined their ability to intermediate long term funds, resulting in reduced availability of long-term institutional finance for the corporate sector. The corporate sector therefore faced a two-pronged squeeze on credit availability - one directly resulting from having to cope with large foreign investment inflows and the other a consequence of the process of financial liberalization.

Thus domestic financial liberalization policies and the externally induced imperative to react to foreign financial inflows, in a way, fed on to each other to produce substantial changes in the domestic financial system. As a result, domestic firms in the non-financial sector operated in

a fairly adverse macroeconomic environment. Evidence from large sample data of the corporate sector indicated that over the 1990s, interest burden of the corporate sector, increased significantly, while its leveraging capability [long-term debt/equity ratios] declined, indicating a reduction in the access of the domestic corporate sector to long-term funds.

To find, how this impinged upon their competitive ability, we looked closely into competitive interaction between foreign and domestic firms. The aggregate level of Foreign Direct Investment (FDI) inflow into the economy, between 1991-99, rose sharply after the institution of the liberal policy regime. FDI inflow, however, remained confined to a few sectors of industry. The six industries that we explore in this study [white goods, consumer electronics, advertisement, soft drinks, telecommunications, power generation] alone accounted for over a third of the total actual FDI inflow. The major industries that attracted the largest share of foreign direct investment during this period, can be divided into two different categories; capital intensive industries [like telecommunication services, electric power generation] that require large investment in fixed assets, and consumer goods industries, either durable or non-durable, where investment in building up marketing and distribution assets are, often, the prime entry barriers and source of rents for incumbents in the industry.

FDI inflow, moreover, has been driven, primarily, by the intent of foreign firms to gain access to the domestic Indian market. Firms with foreign equity participation did not exhibit, on the average, higher export propensity than the domestic corporate sector. Cross border mergers and acquisitions, moreover, has been an important aspect of foreign entry, with foreign firms emerging as dominant bidders in the Indian merger and acquisition market. Between 1991 and end-1998, close to 40% of the financial inflow by way of direct investment by MNCs went to finance takeover of Indian enterprises. Thus, sell-off and exit from industries constituted a major element of corporate India's response to the entry of MNCs over the 1990s.

In the second part of the study, we explore into six industries. In the white goods industry, incumbent domestic firms sold off to entrant MNCs, unable to match their predatory moves. For foreign firms, adopting such strategies in the Indian market was possible because of the parent firms' ability and willingness to underwrite continuing losses in their Indian operations. In colour television industry, however, foreign firms did not invest heavily and the larger domestic firms retained their dominant market share. In the advertisement industry, Indian agencies sold controlling equity stakes to foreign agencies. Given that multinational clients of advertisement agencies prefer to work with the same agency across national markets and that expense on foreign brands dominate the Indian advertisement industry, domestic agencies without affiliation to foreign agencies found it difficult to survive. In the soft drink industry, the ability of foreign firms to underwrite their losses in Indian operations enabled them to pursue strategies that domestic firms could not match, which eventually led to the exit of domestic firms from the industry. In telecommunication services and power generation, where participation of the private sector was a new phenomenon of the 1990s, policies of the State actually discriminated against domestic firms in the public and private sector, while foreign firms in certain cases were provided with

liberal incentives to facilitate their entry. Given the capital-intensive nature of the industries, investment made by domestic private capital was marginal and most of the private investment in these industries were made by foreign firms. Lack of an ability to finance the creation of capacities in these industries was an important impediment for the domestic private sector in entering into these industries.

Case studies of these six rather diverse industries, brought out certain similarities that are particularly striking. Asymmetries between MNCs and domestic firms with respect to access to financial markets, both in terms of price and quantity, was found to be significant in influencing competition in the product market - providing foreign firms with a larger 'strategy space', which manifested itself in various forms. In consumer goods industries, foreign firms incurred larger expenses on marketing and distribution functions, which enabled them to build up marketing assets that helped to beat domestic competition and to erect entry barriers to the industry. The ability of cash rich foreign parents to underwrite losses in their Indian subsidiaries over a prolonged period meant that predatory behavior by foreign firms was a costly but feasible strategy. In industries, like telecommunication equipment, on the other hand, better access to financial resources, enabled foreign firms to use trade credits and vendor financing as competitive tools in the product market. In capital-intensive sectors, like telecommunication services and electric power generation, financial advantage got manifested in better capability of foreign firms to finance investments required to set up capacities.

What emerges, therefore, is the fact that product market competition in oligopolistic industries also has a strategic dimension and since, firms seldom compete only on the basis of cost of production, making strategic investments is important in enabling a firm to hold on to market share or to penetrate new markets. We also argue that asymmetrical access to financial resources played a critical role in influencing the outcome of competition and created a competitive disadvantage for Indian firms. Changes in the macroeconomic environment and financial markets had an important role to play in defining this asymmetrical access and therefore had a detrimental impact on the growth and expansion of domestic capital.

The changes in industrial policy and the liberalization of foreign investment was carried out on the premise that it would lead to the growth of domestic industry, making Indian firms globally competitive. The actual effect of the liberalization initiative has, however, been very different - leading to exit of domestic enterprises from several industries, even when domestic firms did not suffer from disadvantage stemming from technological obsolescence or high cost of production, reflecting, in a way, the failure of industrial policy pursued over this period.