CHAPTER – I

INTRODUCTION: CONCEPTS AND THEORIES

Multinational enterprises (MNEs), the main component of foreign direct investment (FDI) were an entity that evoked caution and hostility from the Third World. Their economic strength was perceived as a threat to the Third World states economic sovereignty. Aware that MNEs were a necessity in view of their technological monopolies and that an individual Third World state was ill-positioned to control this ‘evil’ necessity, these countries sought to build a common front and evolve an international code of conduct to control the activities of these companies. In the nineties, as observed by the United Nations Commission on Trade and Development,

“the trend towards increased flows of FDI world-wide and the creation of a more hospitable environment for FDI continues. Even the Asian financial crisis does not seem, thus far, to have greatly affected either FDI inflows to, or the further liberalisation of FDI policies in developing countries.”

This changed attitude reflects a cycle of economic development strategies adopted and practised by developing countries. The bloc of developing countries that emerged from the de-colonisation phase in the aftermath of the second World War had varying regimes. The characteristics of each political regime owed its origin and derived its power from differing combinations of external and internal factors. These regimes varied from strong democratic government to puppet civil or military regimes. Interest groups within these regimes have largely determined economic strategy in the post-independence phase. In those developing countries which were drawn into the cold war (consciously or unconsciously) the nature of development strategy would tend to replicate the superpower (they owed allegiance to).

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1 For instance, the amendments proposed by the G-77 to a code governing operations of trans-national corporations (TNCs) (proposed by the United Nations Centre on Trans-National Corporations in the mid seventies) was forwarded on the grounds that the code was not adequate to protect the interests of developing countries and provisions for control of TNCs had to be more strict than envisaged in the UNCTC code. Sylvanus A Tieneul, “The Group of 77 Draft Code of Conduct of TNCs: Its Evolution and Negotiating History” in H.W. Singer, et. al. eds., Technology Transfer by Multinational Corporations (New Delhi: Ashish; 1988), pp. 669-704.

In countries which remained neutral to this conflict, development strategy was evolved to respond to pressures from internal lobbies close to the state. As a natural reaction against the phase of economic stagnation imposed by colonial powers, the intellectual milieu in these states advocated an economic strategy where foreign investment was not permitted to stunt the development of domestic enterprises. Consequently, these countries adopted an economic stance which sought to keep the national economy away from a dominating influence of foreign economic interests. The real motives varied. In the case of leftist states, multi-national and other firms which are based in the West were viewed as the new vehicle for exploitation. In other states, the desire to ensure rapid development of domestically owned industries required that foreign firms be banned from operations within domestic economies.

In the late eighties and nineties, most developing countries have abandoned this negative attitude towards foreign investment. From an attitude of permitting limited involvement and excessive regulation, these countries are now involved in a competition to actively seek and enhance foreign investment inflows. This has stemmed from the demonstration effect of several success stories in developing countries which began the present phase of economic development from a very poor base and have attained high growth rates and rapid rise in per-capita incomes. These are the countries termed as the ‘Newly Industrialised economies’ and the ‘Asian Tigers’ (South Korea, Taiwan, Singapore and Hong Kong comprise the first group while Malaysia, Indonesia and Thailand comprise the second). Each of these countries have adopted varying policy-approaches towards foreign direct investment (FDI) and used this form of global capital flows in their development process.

The two largest countries in South Asia, which is one of the world’s poorest regions, namely India and Pakistan have undergone a cyclical shift in their policy perspectives and attitudes towards foreign investment. The two countries were active participants of the Third World movement against developed countries in the sixties and seventies. While India had put in place severe restrictions to control the limited foreign investment presence in their economies, Pakistan ensured that foreign investment was kept out of industrial segments where domestic business groups were active. Following a major (but not the only) balance of payments crisis in the late eighties and early nineties, the two countries have dramatically altered their attitudes
and policies vis-à-vis foreign firms. They have now joined the developing countries community in actively seeking FDI inflows. The present study focuses on issues concerned with FDI in the two countries in order to understand the changes and its potential implications for economic development strategies and performance.

It is important to locate this phenomenon within the economic reforms doctrine that serves as the base for the present economic development strategy in the two countries. This doctrine has been formulated at a time when the two countries have approached the International Monetary Fund (IMF) for assistance in a balance of payments crisis faced in 1988 by Pakistan and 1991 by India. The two countries have approached the IMF at various points of time in their economic history. The uniqueness of the 1987 and 1991 crisis lies in the fact that this coincides with the shift in state attitude towards FDI. This changed attitude is represented by major initiatives on attracting FDI in economic reforms doctrine that guides the present phase of economic development (unless otherwise stated, the term ‘reforms’ refers to the changes in economic policy brought about in the aftermath of the 1987 and 1991 agreements with the IMF).

This chapter serves as an introductory discussion of two important concepts that are involved in this dissertation and the linkages between them at the level of theory and practice in the global scenario. These are FDI and the development crisis faced by most developing countries including the countries that have been chosen for this dissertation. The origins and evolution of capital movements across international borders, its diverse components and the advantages of FDI as compared to the other components is discussed in section 1.2. The theoretical perspectives evolved in the past fifty years to study this concept from the perspective of the firm and the home country is studied in section 1.3. Section 1.4 analyses the role played by FDI in the development process and assesses its viability in addressing problems faced by developing countries. Existing literature on the role played by FDI in the two countries before and after the initiation of structural adjustment policies and the lacunae in literature are studied in section 1.5.
1.2 INTERNATIONAL MOVEMENT OF CAPITAL

Global capital flows are a by-product of colonial expansion which followed from the seventeenth century industrial revolution in Europe. It began as a means of finance for the exploitation of natural resources in colonial regions. The process of industrial revolution had increased the demand for natural resources as a source for industrial inputs. Since this demand could not be entirely satisfied through internal sources, the process of exploiting the resources of colonies began. This was financed through capital from colonial countries. Resource extraction FDI was followed by investments in raw material processing and trading, particularly the import of colonial industries' products into the colonies. There were some investments in support services like railways among others.

1.2.1 Categorisation of Global Capital Flows

In the present context, global capital flows have assumed several forms. Based on the nature of source, these flows can be grouped in two broad categories. The first is aid from government and international organisations (funded by member states' governments). The chief characteristic is that these are determined more by political factors than pure economic factors, carry a low interest rate and its attainment of efficient utilisation is largely determined by recipient governments. The second is private capital flows which are chiefly determined by economic factors such as security of capital, ease of repatriation and potential rates of return. These are indirectly affected by political relations between home governments and host governments to the extent that positive relationships reduce political risks of these flows and thus are cheaper to obtain.

Private capital flows can be further categorised in three groups. The first is private funds that flow to the government of the host country. These originate from financial

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3 In 1913 about 60 percent of British overseas investment were in the rich primary producing regions of Australasia, North and South America. According to an estimate, 10 per cent was directly invested in mining and raw material extraction, 40 per cent in Railways and 15 per cent in social overheads and internal improvements which had its utility for resource extraction. See J.H. Dunings, Studies in International Investment (London: Allen & Unwin; 1970), p. 17.
institutions such as banks, mutual funds and pension funds which are either transferred as commercial loans to host governments or invested in government securities. The second is foreign portfolio investments where funds from private financial bodies are invested in stocks and securities, bonds and other debt instruments of the private sector in the host country. Most investment of this nature flows into the stock exchanges of the host country. The third is FDI were private entities invest in operations either through wholly owned subsidiaries or joint ventures in the host country.

The main factor that functionally distinguishes FDI from portfolio investment is control over the operations financed by foreign investment. In portfolio investment financial resources are transferred from the owner of the funds to financial markets of the host country to be used for either speculative purposes or finance operations of other entrepreneurs. There is no entrepreneurship involved by the owner of the fund. In FDI the investor and the entrepreneur are the same and therefore control rests with the investor himself or the investing firm. The concept of control (vis-à-vis proportion of equity held by the foreign investor) varies from country to country. While some countries consider a substantial stake (30 to 40 per cent or more) as adequate to be classified as FDI others insist on complete control (over 50 per cent). Joint ventures represent a grey area where control may be distributed between domestic and foreign investors. For statistical purposes, this study will use foreign investment classified as FDI by government sources as the definitional basis. In the descriptive analysis any significant control vested in foreign investors will be included as FDI since the objective is not on foreign investment inflows per se but implications which flow from the policies behind these investments.

1.2.2 The pre-eminence of FDI

FDI in the pre-1930s lacked a distinct identity in economic theory and was generally analysed in the framework of either trans-border capital flows or business organisation theory. Classical analysis of international capital flows had focussed on interest rate differences as the primary motive for these capital flows. Since FDI involved not just capital movements but also production and other activities, this concept could never be fully analysed within the framework of
international capital flows. The need for FDI to be analysed as a distinct concept arose from its growing importance during the inter-war period. It was during this period that the resilience of FDI over portfolio investment was revealed. While the Great Depression of the 1920s rapidly eroded the value of existing portfolio investments (new outflows were severely reduced while net outflows were negative) there was an increase in the volume of direct investment. In the post-Second World War phase, despite the introduction of new instruments to facilitate international capital movements, direct investment dominated over portfolio investments\(^4\), a trend that has continued since. This trend led to a proliferation of theoretical studies on FDI and its evolution as a distinct concept. Even while borrowing inputs from business organisation theory, FDI studies began to focus on factors exclusive to outward investment expansion by business firms.

Foreign direct investment has two forms. One is in the form of vertical integration whereby a firm decides to expand into extraction and processing of its raw material input or further processing of its existing output. This is characteristic of intermediate goods producers like oil companies, chemical and mineral processing industries \textit{et.al.} The second and more common form is its expansion of current activities in other countries either to service local and international markets or its own home markets. Theories that have been formulated to generalise and explain these various forms are discussed in the next section.

\subsection*{1.3 THEORETICAL PERSPECTIVES ON FDI}

The shift from resource extraction oriented FDI that accompanied colonial expansion to manufacture oriented FDI has been a post-second World War phenomenon. In this global scenario where all pre World War colonial powers such as UK, France, Germany and Japan were in economic shambles, it was the private sector in US that initiated a substantial expansion of firm operations beyond national borders. Gradually as the Marshall Plan yielded results in terms of economic reconstruction in

\footnote{ibid, p.20.}
West Europe, firms from this region also began external operations on a substantial scale. Hence most early theories on FDI have their origins from the West.

1.3.1 The Western interpretation

As discussed earlier in this chapter, capital movements across national borders were first studied under the framework of interest rate differences where capital constantly moved in search of higher interest rates. Later the aspect of risk was incorporated in the interest rate framework. This approach had its deficiencies when capital movements in the form of FDI was being studied since interest rates and risk factors were not adequate for explaining motives behind the desire for control over investment operations beyond national borders.

Theorists such as Ricardo, Hume, Mill, Bastable and others studied these capital movements (citing differential rents for capital) and its effects on money supply and the level of economic activity in the host and home country. Later changes in these theories advanced by Keynes and other Keynesians were primarily concerned with some changing circumstances such as introduction of paper standard, fixed exchange rates and controls on international trade and capital movements.

A concept introduced in FDI analysis, which it shares with general theories of the business firm is that of the firms ownership of an 'advantage'. Advanced first by J.S. Bain and later expanded upon by Kindleberger, this 'advantage may be either a brand, a new product, technique of production et al. The concept of a firm's 'advantage helps to bring out a clear distinction between portfolio investment and FDI. While portfolio investment is the response to the availability of only financial capital, direct investment is a consequence of a real 'advantage. The exploitation of this 'advantage can be undertaken only through FDI or licensing and therefore portfolio investment cannot be considered as an alternative or substitute for FDI.

The ownership of an 'advantage then induces market imperfections leading to the creation of oligopolistic or monopolistic markets. A firm will strive to maximise

returns from the ‘advantage it owns within its home market. As its market share and profits grow, competition grows when competitors develop close substitutes for this ‘advantage’. This competition limits each firm’s attempts to expand sales and profits. Similarly as competition grows, prices of production factors also rises leading to rising costs and reducing profits.

Firms in these markets expand abroad for several reasons. First the very presence of untapped foreign markets represent potential returns for a domestic firm’s ‘advantage’ and therefore these firms must strive to tap these markets (since the basic characteristic of each firm is assumed to be the desire for profit maximisation). Secondly there is the defensive strategy whereby foreign investment is the response of a firm when it perceives a threat to its market share in external markets. Thirdly a foreign market may provide better advantages in the form of cheaper production inputs like labour and raw materials. This can be termed as the locational advantages a firm derives by expanding abroad.

It remains to be seen as to why a firm would prefer the route of FDI rather than exports or licensing (if the motive is to exploit a foreign market) in order to capitalise on its advantages. In other words, a firm has to expect greater returns by internalising the process of exploiting its ‘advantage’ in a foreign market rather than adopting the route of exports or licensing. Direct investment is preferred to exports if a foreign market, where costs of production is the same as in the home market of the firm, has high tariff walls. Similarly direct investment is preferred to licensing when a firm possessing an ‘advantage’ believes that it can maximise its profits or protect its ‘advantage’ by directly investing rather than licensing. In licensing the probability of the licenser firm not possessing the requisite capacity to maximise the returns to the ‘advantage’ or even appropriating the ‘advantage’ is a deterring factor. Aliber introduces the currency area phenomenon approach to FDI analysis. Exchange rate

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6 If one firm believes that its competitor would invest abroad, it would mean a long term disadvantage since the investing firm would increase profits and grow in size thus acquiring domination over the first firm. Another threat perceived is that domestic firms in foreign countries may imitate the firm’s advantage and thus appropriate a part of the firms share in the foreign market. see Raymond Vernon, 'International Investment and International Trade in the Product Cycle', Quarterly Journal of Economics, Vol. 80, pp. 194-8.
differences reflect on costs of investible funds and therefore induce difference in capitalisation rates obtainable by a source country firm and host country firm. This capitalisation difference determines the route preferable to the firm holding an 'advantage’in capitalising its advantage.

A potential FDI firm faces certain disadvantages in the foreign market. This includes lack of knowledge about the market, communication difficulties with headquarters et.al. most of which involve a one time fixed cost to overcome. Contrasted to this is the scale advantages derived by expansion of the firm’s operations. A firm intending to invest abroad has both advantages and disadvantages. When advantages outweigh disadvantages a firm will take a positive decision on investing abroad. An additional motive for FDI terms this phenomenon as an attempt by large firms to reduce risk exposure through diversification of investment. Though the route of portfolio investments or loaning out capital is available to these firms, the existence of foreign markets with imperfections, which impose costs on the investor adopting these routes, results in investors adopting the route of FDI for spreading their risk exposure. This is more so in the present international economic scenario where cyclical changes in economic activity is not uniform across countries. Therefore if a firm’s foreign subsidiary is affected due to recession in its market, the resultant loss to the firm can be absorbed through profits generated by the firm’s home unit and other subsidiaries whereby the firm’s overall profit is not seriously affected.

Raymond Vernon, through a study of American FDI formulated the product cycle theory which provides a generalised time frame within which firms invest abroad. He assumes the firm’s ‘advantage’ to be a new product or innovation. At its initial stage


8 For a detailed elucidation of these disadvantages see S. Hymer, 'On Multinational Corporations and Foreign Direct Investment' Ibid. pp. 27-33.

9 Donald R. Lessard, 'International Diversification and Direct Foreign Investment' Ibid. p.119. Lessard’s contention is that multinationalism is a response to market imperfections particularly for technology and other real factors of production.
it requires both a well developed market where it can be successfully promoted and the necessary technical expertise for production. The promotion of a new product also involves high marketing costs, and servicing. Given these requirements, his hypothesis is that new product development would only take place in industrial economies which have an advanced technological base and relatively high per capita incomes. Production of these goods would be undertaken in the location of its development. At the second stage, the product gains wider acceptance and an international market for these goods is feasible as a result of which production is increased and exports of this good begins. Simultaneously competitors develop close substitutes. In the third stage the product becomes highly standardised and can be produced in comparatively inferior locations. With competition increasing, particularly from foreign entrepreneurs and pricing becoming the decisive factor, production cost considerations assume dominance and production is undertaken in foreign locations to reap cheaper cost advantages. Third country markets too can be serviced by foreign production activities\(^\text{10}\).

1.3.2 The Emergence of Alternative Perspectives

Until the seventies, most studies originated from the West and therefore were based on studies of US and West European FDI (both inward and outward). These suffered from a fundamental deficiency in that their studies mainly focussed on FDI flows into industrialised countries like Canada and UK. The shortcoming was that their analysis could only explain how FDI could help in overcoming problems associated with war induced economic crisis and not those associated with the low economic development status of developing countries. The only references to developing countries were FDI in resource extraction industries. Therefore these theorists failed in analysing the role FDI could play in inducing all round economic development in developing countries.

In the seventies, Japanese analysts including Kiyoshi Kojima and Ozawa highlighted the need to evolve an alternate approach in the study of FDI which could explain rapidly growing Japanese FDI particularly in South-east Asia. This had an advantage over those theories that originated from the West since they were concerned with the role that FDI could play in bringing about economic development

\(^{10}\) ibid, pp. 45-53.
in the Third World. Though the approach they evolved did not have any fundamental changes particularly when studying the motivation of FDI, it was a departure from existing theories. Even before the seventies, Akamatsu had propounded the ‘flying geese pattern to chart out the course that developing countries followed when using FDI for development\(^{11}\). Initially new products which were developed in industrialised countries were imported into developing countries. As demand grew for these products, indigenous manufacture through subsidiaries and joint ventures followed. Later as local firms gained experience in manufacturing these products, production would increase and exports would be undertaken. In the final stage the host country would develop the capacity to manufacture new products and production of older products would be shifted out to other developing countries.

Studying FDI originating from Japan, Kojima provided a new dimension to the motives behind FDI. He accepts the concept of Vernon's product cycle but tends to differ on the timing and motivation of a firm in undertaking FDI. Rather than concentrating on a firm per se he generalises FDI as an industry phenomena. His observation is that industries which are no longer comparatively advantaged by locating themselves in Japan tend to move out into other countries where the comparative advantage is higher. Production is undertaken not just for the host country market but home market and other third country markets. He stresses that Japanese FDI moves out only when it is more profitable for an industry to locate its operations abroad. Therefore effectively there is no competition between Japanese FDI operations and domestic industry\(^{12}\), a point which Vernon stresses, is manifest in Western type FDI\(^{13}\).

The importance of Japanese FDI as characterised by Kojima lay in the fact that it had the potential to create trade and help developing countries use FDI in promoting development. Similarly FDI was targeted with a view to utilise the host country's


\(^{13}\) As seen before, Vernon's thesis is that FDI from the US originated out of a need to protect foreign markets or utilize cheaper production inputs. In the former case domestic production continued but the existence of cheaper production costs abroad render domestic operations nonviable leading to industrial disruption, labor resentment and protectionist measures to protect the high cost domestic industry. See Raymond Vernon, 'The Economic Consequences of US Foreign Direct Investment', *US International Economic Policy in an Interdependent World, Paper I* (Washington D.C.), July 1971, p. 936.
advantages particularly surplus labour and therefore was conducive for developmental efforts. The superiority of Japanese FDI over US FDI can be seen in the progress recorded by South-east Asian countries (which generally saw a predominance of Japanese FDI) as compared to South America (where US FDI was the most dominant)\(^{14}\). Ozawa underscores this fact when he points out that Japan has consciously decided to move its firms in low technology, labour intensive industries and resource processing industries to countries that have advantages in processing of resources, surplus labour supply, low levels of industrialisation et. al.\(^{15}\).

The evolution of a firm from a national status to a trans-national status as theorised by Vernon and Kojima is compared in table 1.1.

### Figure 1.1: Product Cycle and FDI Cycle

<table>
<thead>
<tr>
<th>Stage I</th>
<th>Vernon's Product Cycle</th>
<th>Kojima's FDI Cycle</th>
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<tbody>
<tr>
<td>Stage II</td>
<td>Domestic Production and Exports.</td>
<td>Domestic Production and Exports.</td>
</tr>
<tr>
<td>Stage III</td>
<td>Standardisation of Product.</td>
<td>Standardisation of product.</td>
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<tr>
<td>Stage IV</td>
<td>Competition from other producers in the home country for foreign markets, and domestic entrepreneurs in foreign markets.</td>
<td>Increasing costs at home and disadvantages in home production.</td>
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<tr>
<td>Stage V</td>
<td>Using FDI to protect market share.</td>
<td>Shifting production abroad.</td>
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<tr>
<td>Stage VI</td>
<td>Sourcing from foreign subsidiaries.</td>
<td>Sourcing from foreign subsidiaries.</td>
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</table>

It is at stage four that the difference between the two interpretations arise. In Vernon’s hypothesis, FDI is a function of increasing competition to a firm’s standardised product which arises from two sources. First, the profits accruing to the firm from the product induce other firms to compete in the same line of product. Second, as a foreign market is created and expanded, domestic producers within these foreign markets to begin producing and marketing identical products or close substitutes. The original firm resorts to FDI to protect its markets. In Kojima’s hypothesis, FDI is a function of efficiency, arising in a firm’s quest for efficiency and lowering costs of production.


There have been several critiques to the Japanese interpretation which have come mainly from Western scholars. A common criticism is that these studies tend to ignore the severe protectionist barriers set up by Japan to ensure that its domestic firms were insulated from foreign firms and internal competition was regulated. Therefore Japanese firms never faced the problems that Western firms faced due to competition from foreign firms. This is part of the reason why the difference at stage five in the figure arises since the Japanese government (Ministry of Trade and Industry) regulated internal competition but exerted pressure on selected companies to consistently expand particularly into external markets. Similarly a criticism raised was that as Japan itself was a technology lagger as compared to the West, its FDI was not as capital intensive as Western FDI and therefore met with a larger degree of success in South-east Asia.\(^{16}\)

In the organisational approach, new studies tend to focus more on the internalisation motive of FDI. Other new approaches include the adaptation of the theory of governance forms and also known as the ‘institutional approach.’ This tends to focus on the socio-economic systems that prevail in home and host countries and its influence in determining the nature of FDI particularly the differences in organisation of FDI in developing and developed countries.\(^ {17}\)

The role and contribution of FDI in enhancing social welfare and redressing problems of developing countries is also a major focus of analysis in several studies. A dominant theme in the Japanese contribution to FDI literature has been the impact of FDI in international trade particularly its trade creation potential for host countries. Similarly the issue of FDI’s role in employment creation is also a major theme of analysis in most FDI literature. The dimension of technology transfer is an additional source for a major debate in FDI literature.

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\(^{16}\) This is the main contention of several works such as J. Morris, ed., *Japan and the Global Economy* (London: Routledge; 1991).

A major feature that marks most analyses of country policies vis-à-vis FDI is its comparative nature. The eighties have seen a major shift in development strategies adopted by developing countries. Following the success of South-east Asian countries in using FDI to hasten the industrial development process, other developing countries have begun to favour this route abandoning the focus on efforts at import substitution and domestic development of technology. Simultaneously, the breakdown of the socialist countries of east Europe has also increased the number of claimant countries for available foreign direct investment resources. The competition among developing countries has encouraged a series of studies aimed at comparing FDI policies of developing countries. Similarly there have been comparisons between developed countries and developing countries in attracting FDI and comparisons between different regions.

1.4 FDI IN THIRD WORLD DEVELOPMENT

The origins of FDI lie in the colonial phase of the global economic system where capital and management from a colonial power would migrate to the colonies and set up trading firms. The next step would be to enter other fields such as mining, plantation agriculture, railways etc. Investment in manufacturing would be restricted to industries where there was no risk of potential competition to home industries. The next step in the evolution of FDI was the growth of FDI outflows from US aimed at producing close to external markets. This was largely confined to the war ravaged West European countries and Canada since most large developing countries frowned upon such investment aimed only at domestic markets, and had the potential to stunt

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19 A typical example is that of jute, tea (dominated by British) and cotton (dominated by Indians) industry in pre-independence Indian sub-continent. Since the basic raw material jute or tea was not available in Britain, unlike cotton, there was no development in jute or tea processing in UK. Hence several British entrepreneurs started the jute and tea industry in the subcontinent and dominated this industry until independence. In contrast since cotton textiles was an established industry in UK, there was no British investment in this sector. Most pre-independence investment in cotton textiles were undertaken by indigenous entrepreneurs.

20 As one scholar puts it, "US firms have been shrewdly using their resources to gain dominant positions overseas roughly equivalent to those they have acquired in this country". Richard J. Barber, The American Corporation: Its Power, Its Money, Its Politics (New York: E.P. Dutton; 1970), p. 256.
indigenous industrial development. This was also the threat perceived by South Korea and Japan while formulating their policies towards FDI.

As developing countries lacked the domestic scientific human resource, capital and technology base, certain sectors like mining and pharmaceuticals would have to be opened for FDI if there was to be any resource exploitation. In non-representative developing countries, this did not pose a problem to relations between the host state and foreign owned firms. Nigeria is an excellent example where the military regime forged close relations with Shell, granting lucrative terms to the company and extracting personal benefits from the company. In contrast, such tensions rose in relatively representative democratic countries with regimes which were oriented towards indigenous development of economic capability rather than act as a dictatorial regime without concern for indigenous development. India\(^{21}\) and Mexico\(^{22}\) (at varying points of time) are good examples.

The Third World states attitude towards FDI depends on the perception of the local business elite of their inherent capabilities and the potential role of foreign firms. In some states, local business groups which have the confidence to undertake industrial investments assume the character of a national bourgeoisie opposed to foreign penetration because of the concrete economic threat posed by multinationals to their own interests. In other states these business groups view themselves as a comprador elite eager to ally with foreign companies and identify their own interests with the foreigners' welfare\(^{23}\). In states where there is substantial presence of both groups, foreign investment policy is designed to accommodate the interests of the two.

\(^{21}\) In its stand towards IBM, the Indian government put the interest of ensuring wide-spread computer usage in India rather than permitting IBM's strategy of sales and service of a few expensive used systems with a time lag of over eight years between the introduction of a product in global markets and its introduction in India. Other foreign owned firms such as Burroughs were permitted to operate with domestic share holding and introduction of latest products. Joseph M. Grieco, "Between Dependency and Autonomy: India's Experience with the International Computers Industry" in Theodore Moran, ed., Multinational Corporations: The Political Economy of FDI (Massachusetts: Lexington Books), pp. 55-81.

\(^{22}\) The Mexican state too had actively intervened, through a public sector body, to ensure that a monopoly resource for the pharmaceutical industry was not extracted cheaply by the trans-national pharmaceutical firms through manipulation of the poverty of farmers. Ibid.

\(^{23}\) See the Introduction chapter in Ibid.
Countries like Japan, South Korea and India are good examples of the first group while Pakistan offers an excellent example of the third group.

1.4.1 FDI in East and South-east Asian Development

The eighties and nineties brought the south-east Asian region into focus for its phenomenal economic growth based on an export oriented strategy. The countries of the region offer two specific models for studying the utilisation of FDI by a state growth strategies. While the first model comprises Japan, South Korea and Taiwan, the second model comprises other fast growing countries of the region namely Singapore, Hong Kong, Malaysia, Thailand, Indonesia and lately China.

In the first model, import substitution was an important goal of economic development. Japan set the trend where state-fostered growth of the domestic private sector was achieved through careful screening of FDI investment, compelling these firms to co-opt local firms as partners and share technology with other domestic firms. This was accompanied by constant state pressure on selected domestic firms to innovate on these technologies, develop their own products and focus on exports. Protection of domestic markets meant that these firms were not required to divert resources on planning and devising strategies to counter potential competition from foreign firms for the home market.

South Korea and Taiwan focussed their efforts on protecting sectors where domestic firms were capable of building strength, inviting FDI in export oriented ventures and state fostered growth of domestic firms and routing them into building independent globally recognised brands and achieving high export growth. A common instrument used by all three countries was a biased regulation of the financial system towards this goal where domestic firms selected by the state would be granted access to liberal low cost capital.

The second model was in many respects, similar to the first model. In their strategy features that were adopted from the first model included attracting foreign investment into the export sector, thrust on co-opting domestic firms as partners and state patronage of selected industries. Where it fell short was on ensuring that domestic firms achieved the high rate of technological innovation and brand ownership as in the first model. The overwhelming presence of foreign owned firms did have a demonstration effect to the extent that it lead to a proliferation of numerous small and efficient firms with global competitiveness in terms of cost of operations\textsuperscript{25}. But these firms remained as small scale ancillary units and sub-contractors for large foreign owned firms. In essence, these countries evolved themselves as mere labour sub-contractors for foreign firms\textsuperscript{26}.

The main disadvantage of the second model is that the host state has no exclusive advantage to offer which cannot be replicated by a potential competitor country. A backward developing country entering the FDI market (at a later stage) would be able to offer cheap labour. It can build up its infrastructure by privatising existing facilities, and courting FDI or multilateral financial institutions for new investment. In contrast, the previous entrants would find it next to impossible to keep wage rates down in an environment of rising industrial activity. Part of the reasons for the 1997 crisis that hit this region can be attributed to this deficiency since the cheap labour advantage of these countries was being gradually wiped out by the entry of China in the competition for attracting FDI.

In the late eighties, China has emerged as a major focus of analysis for studies on FDI and development. Following a very gradual opening up of its economy, foreign

\textsuperscript{25} To an extent this has been attributed to cultural factors, domestic entrepreneur in most south-east Asian countries with the exception of South Korea and Japan are ethnic Chinese. As and analyst sees it, Chinese family businesses, who are spread all over the countries comprising the second model, are quick in decision making but suffer from deep organisational incompetence. The Japanese, he asserts are the reverse and hence they can build up a network of large organisations which are the backbone of the success of their business corporations. The South Koreans he feels are somewhere in between. Jim Rohwer, Asia Rising (London: Nicholas Brealey; 1995), pp. 208-9.

\textsuperscript{26} For example Malaysia has attracted considerable foreign investment in the electrical and electronics sector. Despite the long period since their presence, the local content is very low and is attributed to lack of reliable local firms who can supply the necessary inputs to foreign firms. ESCAP, Foreign Direct Investment in Selected Asian Countries: Policies, Related Institution-Building and Regional Cooperation (Bangkok: ESCAP, 1998), p. 109.
investment was permitted only in specific locations. It was in three phases spread over 12 years that China has opened up the existing zones where FDI is permitted. Similarly, foreign owned enterprises have been granted preferential benefits over domestic enterprise (mostly state-owned). Through permissible equity limit regulations, FDI is guided into high technology and export oriented sectors\textsuperscript{27}. The closure of areas other than those permitted, ensures that FDI does not have free access to the large Chinese domestic market. Special tax concessions provided to entrepreneurs from Taiwan and among the overseas Chinese community has also prompted relocation of low value added labour intensive production units into China. Decentralisation within a narrow base (local bodies in permitted zones) has also helped in reducing bureaucratic red-tape since a small community of bureaucrats are involved and can be encouraged to respond efficiently to foreign proposals. The absence of a substantial domestic private entrepreneurial community has also ensured that internal dissent against preferential treatment is non-existent.

The net effect is the same as the second model referred to earlier, namely China is marketing itself as a huge factory for foreign firms. The province specific approach of China is an assurance against any potential new entrant in the host state market which might offer cheaper labour. When labour incomes in the existing liberalised provinces rise as a consequence of industrialisation, new provinces can be opened up and the wage rate brought down. This is a medium term strategy and the utility of this strategy in the long run is limited when there are no new provinces to open up.

An important component of the East and South-east Asian success is the role of foreign policy imperatives of the US led strategic alliance against the erstwhile Soviet bloc. The region has a huge poverty stricken population and several countries with socialist regimes which had a potential to expand their influence into non-socialist countries within the region. Hence economic development in the region was a vital imperative of US Cold War imperatives. This link has been established through several means. First, the pioneer of capitalist development in the region, namely

\textsuperscript{27} Ibid. pp. 52-69.
Japan, was accorded preferential treatment in terms of access to US technology\textsuperscript{28}. Similarly, Japanese exports were granted easy access to US markets despite protests from domestic companies over Japan's protectionist policies. This second option was further advanced to the other non-socialist countries of the region, the last instance being that of China\textsuperscript{29}. Thus, when faced with rising labour costs at home, Japanese, South Korean and Taiwanese companies found it convenient to shift to other countries of the region without any threat to their export markets in US\textsuperscript{30}.

1.4.2 The Development Crisis, Structural Adjustment and Expectations from FDI

It was becoming evident, during the eighties, that several developing countries in South America, Africa and Asia who chose to focus entirely on import substitution, had failed in achieving high growth or reducing their import dependence. This was largely due to the incompetence of political leadership, bureaucracy and private sector entrepreneurs. This failure of domestic forces prompted a change in strategy, particularly a reorientation of the role of the main actors. Since domestic forces had failed, it was felt by policy makers and the intellectual community that less government intervention in economic decision making and a larger role for foreign firms in industrial development was the solution. Multilateral financial institutions which were involved in financing the crisis recovery programs of these countries too were enthusiastic in supporting this thesis.

The crisis faced by most domestic countries had two dimensions, an internal and an external. The internal crisis would inevitably lead to the external crisis. The manifestation of the crisis was in the form of unbalanced government finances. The immediate effect would be a foreign exchange crisis where the reserves of the country would go down to precarious levels threatening vital imports. The fundamental

\textsuperscript{28} Ryutaro Komiya, n. 24.

\textsuperscript{29} In the case of China too, there were considerable protests against the lax copyright regime in China. Except for public pronouncements, no action was taken against Chinese exports to US.
problem, as highlighted by these institutions particularly the International Monetary Fund (IMF), was structural deficiencies in the economies of crisis-hit countries, which necessitated a correction.

The concept of structural adjustment per se has always been associated with the IMF. Therefore when liberalisation of a policy regime occurs simultaneously with the initiation of a structural adjustment program (SAP) it is assumed, particularly by critics of the government, that these reforms are forced on the government by the IMF. This is not so. The IMF's main goal during the negotiations preceding an SAP, is to ensure that the recipient government removes the causes of the crisis. This involves primarily the overspending by the government and the weakness of the crisis affected states' export potential.

The immediate cause for a structural adjustment program as required and directed by the International Monetary Fund (IMF) is a major deficit in the balance of payments account of a country which leads to a situation where the country under reference is under serious threat of default in its international financial commitments. As correctly identified by the IMF, such a situation normally arises due to 'fiscal irresponsibility' indulged in by the government of the crisis engulfed country. This diagnosis applied to India and Pakistan.

The conditionalities dictated by the IMF are designed to correct deficits incurred by the governments under various accounts (fiscal deficit, current account deficit and budget deficit). A common target in this is reduction of government expenditure on the public sector. There are two components to a recovery program, macro stabilisation covering broadly fiscal policy, monetary and credit policy, exchange rate


31 Such a diagnosis is not always accepted unanimously as in the case of the south-east Asian crisis where there was a view that the crisis was essentially a temporary foreign exchange problem and did not necessitate a structural adjustment program. The first three decades of IMF's operations was limited to arranging foreign exchange assistance to countries suffering a crisis without the insistence on an SAP. It was in the eighties when a number of developing countries suffered such a crisis that IMF's insistence on the SAP began.
adjustment with the thrust on demand compression to reduce the imbalance in government finances. The second component covers structural adjustment as such i.e. trade policy reforms, industrial policy reforms, public sector reforms, factor market reforms, tariff policy and administered price policy. These are oriented towards increasing growth and supply by imparting competitiveness, efficiency and dynamism to the system.

As financial resources of the IMF is involved in the recovery process it is natural to expect that the Fund would impose conditions on the debtor country. But these conditions go beyond mere safeguards of the Fund’s resources. As the Fund in collaboration with World Bank also plays the role of the global guardian of the international banking and financial system, the broad objective of the Fund-Bank strategy has been to ensure that the economy of the crisis-hit country is reformed not only through short term measures of stabilisation but through long term measures aimed at revamping economic development strategies. This serves to guarantee the repayment ability of the country and its creditworthiness in global financial markets. As concluded by an economist, the Fund-Bank’s strategy has an inherent message which is the key to ensuring the success of the larger agenda.

The primary development objective is maximising growth by allocating funds based on the criteria of highest money rate of return, when prices of goods and factors will reflect their respective scarcity values not only in the domestic but also in the global context.

One important element in this strategy which is of direct relevance to the present study is reforming the industrial investment and regulation regime. The reforms proposed are formulated so as to ensure that allocation of resources are determined not by the state but through the market. Similarly the emphasis on the global context requires that the economy is open to global forces rather than restricted to national forces, whether public or private. The need to put in place an open and liberal regime vis-à-vis FDI policies arise from this objective and are recommended by the Fund-


33 SP Gupta, “Introduction: Recent Economic Reforms and their Impact” in Ibid. p. 3.
Bank combine. In such a regime foreign owned firms would be treated on par with national firms, have the freedom to operate in all sectors of the economy and be permitted to repatriate earnings and investment capital freely.

For the host state, an important motive in reforming the FDI policy regime is linked to the need to increase foreign exchange earnings. Most developing countries continue to depend on foreign sources for several vital imports. These include machinery, industrial inputs, fuel, fertilisers and in many cases food. None of these can be termed as non-essential or avoidable. Past efforts to achieve self-reliance have not achieved much as the statistics of imports by developing countries indicates. It is the failure to earn sufficient foreign exchange that triggers off the balance of payments crisis. The success of South-east Asian countries in attracting FDI and using this form of private investment as the leading actor in the export led strategy has created the euphoria in developing countries that the entry of modern day version of FDI signifies potential success of export growth goals.

This hypothesis has been actively promoted by multilateral financial agencies too. A proper study into the South-east Asian model before its adoption is the casualty in the enthusiasm to emulate the success on the export front. The model that has caught the attention of the developing countries is the one adopted by Singapore, Hong Kong, Malaysia, Indonesia and Thailand. Here the one point thrust on the conventional concept of comparative advantage where the abundant availability of labour is combined with modern technology, machinery, management techniques, and capital all provided by the foreign owned firms to manufacture labour intensive products appears very attractive. The presence of foreign firms would ensure that global marketing of this output is not neglected. The promise it holds in terms of forcing domestic industry to emulate efficiency standards appears as an additional advantage.

To an extent, the enthusiasm of developing countries and the stress by the Fund-Bank combine on this model rather than the model offered by Japan, South Korea and Taiwan is justified. The crisis-hit developing countries have suffered from incompetence of the bureaucracy-political leadership-domestic industry combine. Hence any strategy involving active leadership by this combine is potentially
doomed to failure. Rather, the need to protect national interests would be better served through insistence on domestic share holding as has been followed by Malaysia and Indonesia.

The South-east Asian crisis has led to some doubts on the suitability of these models. Critics of globalisation and free international movement of capital have used this crisis to condemn this trend. It is important to distinguish between the two forms of foreign private inflows in this context. As had been discussed, portfolio investment is unstable and can lead to considerable outflows at the smallest signs of a crisis. In contrast, direct investment is more stable and responsive to long term trends. Therefore a crisis induced by withdrawal of direct investment can occur only over a period of time giving the Central Bank, time to manoeuvre a way out of the crisis. Withdrawals of foreign portfolio investments in contrast can flare up within hours and render Central Banks helpless unless regulatory measures are imposed which would involve reneging on sovereign guarantees on foreign capital remittances.

The sole role of portfolio investment in inducing, and worsening the crisis has generally been overlooked by critics eager to deride the entire system of global foreign flows and national deregulation regimes. Crisis induced by portfolio investments do have their origins in the nature of the deregulation regime and therefore the role of these regimes must be critically viewed in the event of a crisis. But to deride the entire system and to hold all the components of global capital flows is misdirected. Even the role of portfolio investment in the crisis must not be exaggerated.

The causes for the crisis in the countries that comprise the first model (discussed earlier) and those of the second model are different. For countries comprising the second model, the crisis was being built up in stages until its final explosion in 1997-98. The initial economic boom (1987-94) occurred due to industrial expansion which was financed largely by FDI. In the early nineties, the Mexican crisis led to serious doubts, in the global capital markets, over the viability of portfolio flows into South America. As against this, the high growth of ASEAN member states was an increasingly attractive option. With confidence building up due to the growing trading surpluses, these countries initiated financial liberalisation where capital convertibility was an important reform measure undertaken. The volume of investments flowing into support services increased (in the expectation of future
growth). The rise in real estate values was the main indicator of this trend which is essentially speculative rather than based on real growth.\(^{34}\)

The opening up of China and devaluation of the yuan (in 1992) had serious consequences for the export potential of the Asian tigers and NIEs since China could offer cheaper labour and a more responsive provincial administration.\(^{35}\) As the other countries had only concentrated on attracting the maximum possible investment in manufacturing, the option of changing the economy’s industrial structure towards higher quality goods and thus moving away from direct competition with China was not available.\(^{36}\) Consequently, as export growth fell (table 1.1), so did overall growth rates.

Table 1.1: Export Trends in East and South-east Asia (1980-98)

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<tr>
<td>Indonesia</td>
<td>(-) 3.03</td>
<td>7.63</td>
<td>15.37</td>
<td>9.67</td>
<td>7.29</td>
<td>(-) 8.61</td>
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<tr>
<td>Malaysia</td>
<td>3.83</td>
<td>18.11</td>
<td>30.33</td>
<td>5.79</td>
<td>0.52</td>
<td>(-) 6.90</td>
</tr>
<tr>
<td>Thailand</td>
<td>1.87</td>
<td>44.80</td>
<td>28.95</td>
<td>(-) 1.31</td>
<td>3.25</td>
<td>(-) 6.87</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>9.61</td>
<td>34.78</td>
<td>22.21</td>
<td>4.05</td>
<td>4.02</td>
<td>(-) 7.09</td>
</tr>
<tr>
<td>Singapore</td>
<td>3.54</td>
<td>26.25</td>
<td>24.84</td>
<td>5.70</td>
<td>(-) 0.02</td>
<td>(-) 12.07</td>
</tr>
<tr>
<td>Taiwan</td>
<td>11.04</td>
<td>23.74</td>
<td>13.24</td>
<td>3.71</td>
<td>4.80</td>
<td>(-) 9.42</td>
</tr>
<tr>
<td>Japan</td>
<td>7.16</td>
<td>12.47</td>
<td>10.82</td>
<td>(-) 7.27</td>
<td>2.45</td>
<td>(-) 7.85</td>
</tr>
<tr>
<td>South Korea</td>
<td>14.59</td>
<td>22.95</td>
<td>18.47</td>
<td>3.73</td>
<td>4.96</td>
<td>(-) 2.83</td>
</tr>
<tr>
<td>China</td>
<td>10.06</td>
<td>25.42</td>
<td>27.92</td>
<td>1.53</td>
<td>21.01</td>
<td>0.53</td>
</tr>
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</table>

Note: *Growth rates are the average annual for the period derived from data of exports during the first and last year of the period.

Source: Derived from global export figures obtained from [http://www/olorg.stats.exe.htm](http://www/olorg.stats.exe.htm)

Portfolio investments being the most liquid of global capital investments, these began a hasty exit from the countries of the second model and led to massive pressures on the domestic currency. As the value of the currency fell, domestic manufacturing was


\(^{35}\) The competition among provinces and the autonomy granted to them generated an enthusiasm to rapidly develop infrastructure facilities. ESCAP, n. 26, pp. 56-58. Thus one factor where China was a lagger in the pre-1990s as compared to other countries of the region was gradually remedied.

\(^{36}\) Some efforts have been made as the realization that growing wage rates at home and opening up of cheaper production locations in China and India would make these nations non-competitive. Where they failed was the low level of scientific education and the lack of adequate research personnel due to the attractive pay packages offered in the manufacturing sector. Manuel F. Montes, The Economic Miracle in a Haze, <http://www.asiasociety.org/publications/asean_miracle.htm> December 1997.
affected as it had extensive links with the global economy and hence the exchange rate was a vital factor for the manufacturing sector.

In the case of the first model, large domestic companies which have developed as multinationals (*Chaebols* in South Korea and *Zaibatsu* in Japan) have a weak financial foundation. In the efforts to build these companies within the shortest possible time a common instrument used was liberal bank credit. Since they are built on debts rather than equity, a financial crisis which affects financial health of the region is bound to affect these companies in terms of outstanding loans and future capital requirements. But as identified by a scholar, these countries posed a threat to the industries of developed countries in US and West Europe. Since the companies of Japan, South Korea and Taiwan (which have a global brand equity) are in problems, they would attempt to ‘export their way’ out of the crisis. This would pose a serious threat to the pricing strategies of competitor firms from the West\(^\text{37}\).

The Asian crisis has an important lesson for all developing countries aiming to adopt the route of increased FDI participation in renewed attempt towards achieving the goal of economic development. While those countries with an indigenous technology and global brand base are in trouble, most of these are due to the shortcuts adopted in building domestic private sector conglomerate giants. The most important lacunae is a strong, transparent and healthy financial sector. Yet the strong global market presence of their corporate conglomerates have helped these countries recover to an extent without having to approach the IMF and accept the accompanying conditionalities. In fact, it goes to the credit of this region that only Thailand and Indonesia have had to approach the IMF for an aid package\(^\text{38}\).

There is a tendency in developing countries to treat exports and industrial development as two different compartments. Industrial development is considered essential to eliminate poverty, exports are essential to finance the vital import component of industrial development and domestic food shortages. Hence special export promotion specific measures must be initiated. Rather than taking a holistic

\(^{37}\) This is mainly relevant for Japanese and Korean products (such as computer chips and peripherals, other consumer electronic goods, steel and ships) since they compete with US and West European firms. Lester Thurow, n. 34, p.24.

\(^{38}\) Kevin F. F. Quigley, n. 30.
view that industrial development by itself would lead to increased exports, the laggards of South-east Asia (the second model countries) focussed their efforts on attracting FDI in the export sector through the establishment of export processing zones. This is increasingly gaining the status of the ideal model for all developing countries suffering from a crisis induced by decades of import-substitution based industrialisation.

The fundamental shortcoming in this model is that despite recognition and public pronouncements of the vital necessity for building an indigenous technological base, development efforts tend to concentrate only on the easy route of assuming the role of a production factory. Government efforts to induce development of an indigenous technology base are doomed to fail in a scenario where domestic industry finds it more attractive to follow the trend being set up by FDI firms in importing technology and exporting the output for marketing by the parent firm. This has been repeatedly happening in developing countries and they remain vulnerable to fluctuations in the global economy, fluctuations they have no control over.

Governments in developing countries encourage export promotion in the belief that high export growth rates such as those achieved by the NICs would finance vital industrial import which would help achieve a decent seven to eight per cent growth in GDP. This is viable only in a scenario where the number of countries following this approach are limited, since the world economy has been growing only at about 2-3 per cent per year. The Asian tigers and the NICs have benefited from a pioneer status and the erstwhile Cold war imperatives. This favourable environment no longer exists. Hence it is evident that it is the pattern offered by the first model that promises a measure of long term sustainable industrial development in a rapidly integrating world economy. Therefore the FDI policy reforms in India and Pakistan are being studied in the context of overall industrial and economic development trends.

39 Presently the most fashionable trend among developing countries, extra preference is given to this sector through increased incentives ranging from liberal limits on foreign equity ownership, generous infrastructure services and substantial relaxation from domestic industrial regulations regime. This has been the case with India, China, Malaysia, Indonesia, Thailand, et.al. A study into the various country incentives documented in ESCAP, n. 26, reveals this trend.

40 Repeated crisis in several developing countries in South America and Asia may have different immediate reasons, they all stem from an unequal relationship they share in the global economic system.

41 Lester Thurow, n. 34, p.
1.5 INDIA AND PAKISTAN

In their post-independence history India and Pakistan have gone to the IMF at various points of time. On each occasion, an SAP has been agreed upon. For each country the particular SAP chosen for the present study represents a milestone in the economic history of the respective country. In Pakistan, this was the first SAP signed by a civilian government in the aftermath of the cold war. The cold war phase has an important relevance for Pakistan's economic strategies and the end of this phase required a drastic change. Pakistan had now to contend without the assurance of low cost foreign aid from the West or a lenient attitude of bilateral donors and multilateral aid agencies. Rather she would have to rely more on internal sources of capital and the discipline imposed by the IMF. To what extent does this new scenario affect the state sponsored domestic capitalism particularly in the light of radical liberalisation in FDI policies is an issue to be addressed in the changed context.

India had approached the IMF at various points of time with the same nature of regime in place in each instance. Yet 1991 represents a major change in the attitude of the Indian state. Rather than putting in place temporary measures to satisfy the conditionalities, concentrate on repaying the loan in the shortest possible time and reverting to the old path of development, the government, after 1991, decided to go beyond the stipulations of the SAP and its approach towards economic liberalisation has been more radical than what was required of it under the conditions of the SAP. This makes the 1991 instance of SAP unique in India's economic history.

1.5.1 Perspectives on FDI

In the regional context, most literature on FDI in developing countries tends to focus on South-east Asia, reflecting not just the importance of FDI in the region but also the degree of success achieved by countries of this region in attracting FDI. Even analyses that study Asia as a whole, focus the analysis mainly on South-east Asia.

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42 The specifics of each instance is discussed in chapter 2.

43 For a detailed survey of literature on specific aspects of FDI operations in Third World development, see Nagesh Kumar, Foreign Direct Investment and Technology Transfer in Development: A Perspective on Recent Literature, INTECH, UNU Discussion Paper Series No. 9606, 1996 <http://www.intech.unu.edu/staff/internal/past/kumar.htm>.
These studies Commonwealth Secretariat(1986); ESCAP(1992); Ramstetter(1991) and Rana & Dowling(1990).

Two studies; Lall(1993) and Rana & Dowling(1990) have dwelt on the reasons for South Asia lagging behind South-east Asia in attracting FDI and the efforts of the South Asian countries to address this problem. Papanek(1991) conducts a comparative study of economic regime systems in India and Pakistan. Though this does not specifically study FDI policies it analyses the outlook of the two states on the role of foreign assistance in the development process. The process of structural adjustment, other economic reforms, important indicators such as the savings-investment gap are the focus of analysis in Raghvan(1990). This study also provides useful insight into ground economic conditions of the two countries chosen for the proposed work. As part of a wider study, ESCAP(1994 & 1994a) study the existing policies and incentive schemes offered by the governments in India and Pakistan to attract FDI.

The World Bank and its affiliate, the International Financial Corporation (IFC), have conducted a study (in 1992) on the effectiveness of the FDI policies framed and measures initiated to implement these policies in Pakistan. In the historical context, Ghaffar(1982) and EIP(1982) conduct firm level case studies of FDI firms in Pakistan and compare it to local firms. Mahmood & Hussain(1991) also rely on 1980 data but use new econometric models developed after 1985 in Blomstorm(1988) to study the reasons for the higher productivity shown by foreign firms as compared to local firms in Pakistan. An analysis of the role of FDI in the economic growth of Pakistan is the focus of Shabbir & Mahmood(1992). The effect of FDI on domestic savings in Pakistan is the focus of two studies; Shabbir & Mahmood(1992) and Khan, et. al.(1992). These studies use data of the pre-1988 period and hence any changes caused to the policy changes after the reforms is not covered. Khan(1997) provides a comprehensive study on factors affecting FDI inflows to Pakistan and the relationship between FDI and macro indicators such as national savings etc. This study also analyses the inflow pattern in the reforms phase of Pakistan.

Studies on FDI per se in India are still evolving their conceptual and theoretical base applying empirical and statistical analysis of data with reference to FDI inflows and
operations. At the macro level, the role of TNCs and their Indian subsidiaries in the
growth of the Indian economy has been studied in Aggarwal(1976), Sarkar, ed.(1976),
Lall & Sharief(1983), Lall & Mohammed(1983), Kumar(1990), D'Mello(1991) and
transfer dimensions of pre-1991 FDI in India. Kumar(1996) conducts an extensive
survey of literature on various aspects of FDI performance and impact for developing
countries in general and covers most pre-reform literature in India and Pakistan.

Post 1991 changes in FDI policy and responses are now the subject of some
studies, though they cannot be said to be comprehensive. These include Birtill(1992),
analyses on the post 1991 changes in FDI policy in India, the initial responses from
foreign investors and the early trends in FDI inflows. Siddharthan(1999) conducts an
analysis of select Japanese and European ventures in India through an factual and
statistical analysis of these firms’ strategies and performance in the eighties and
nineties in order to bring out the differences in these two groups of companies.

By far, the most comprehensive work on FDI focusing on the policy angle in India
has been undertaken by the Indian Institute for Foreign Trade (IIFT) (see bibliography
for the full list of reports). This includes a survey of FDI firms in India and of
potential investors in the US about their perceptions and suggestions on India's FDI
policy and its implementation, comparison of India and the South-east Asian countries
vis-à-vis FDI and a detailed analysis of India's FDI policy and the responses in terms
of actual inflows. The major lacunae in this series is that it concentrates on the
process of attracting FDI and ignores other factors such as the perceived shortcomings
in the domestic economy that are sought to be overcome by FDI. Focusing on the
latter aspect will inject a qualitative approach to assessing the impact of India's drive
to attract FDI rather than focusing on a quantitative analysis of FDI inflows.

Another comprehensive work is Pant(1995), which covers policy issues, draws
comparisons between India and some East and South East-Asian countries and studies
the export orientation of FDI firms in India. Raihan Sharif in Sarkar, ed., (1976)
compares foreign private inflows into India and Pakistan and Iran during the sixties.
This study concludes that the two countries accorded more importance to FDI in the
sixties as compared to portfolio investments. But the study does not focus on FDI *per se* and so several dimensions are missed out.

There has been no subsequent work on comparing FDI policies, responses and success achieved in attracting FDI by India and Pakistan. Most studies that base the analysis on macro FDI inflow data for India, use the approval data which is released by the government on a regular basis. While data on total actual inflows is also available on a regular basis, sector break-ups are infrequently published. The Reserve Bank of India has only initiated publication of this data for the past three years. The data on approvals released by the government is exhaustive providing an industry wise break-up with forty broad categories and forty six sub-categories. In contrast, sector-wise data on inflows released by RBI comprises only ten broad sectors. This dissertation has conducted the statistical analysis with annual inflow data supplied by the government and available on an annual basis for 39 categories of industries. By itself, a comparative analysis between data on approvals and actual inflows reveals the problems associated with policy. Moreover, comparing the performance of India on the basis of approvals data with the inflow data of other countries gives erroneous results since there is a wide disparity between the approvals and actual inflow data in each category (chapter four).

The differences in the policy approach adopted by India and Pakistan in the period covered by the present work, have widened over the years. Yet the nature of the bureaucracy, which is the main implementation mechanism remains similar. There is considerable difference in the size of internal markets and resource base which by itself will imply different motives for foreign investment in the two countries. Given these similarities and dissimilarities, the following chapters will attempt to bridge this important gap in the literature on comparative analysis of FDI in Asia and in South Asian development studies.