India

Economic and market development since liberalisation

by Dimple Sahi Bath

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Apart from being the largest stable democracy and a member of the Commonwealth, India is also the sixth largest economy and the second most populous country in the world; its middle class exceeds 250 million, growing at a rate of 10% a year. The economy is largely dependent on agriculture, which contributes nearly 40% of the gross domestic product (GDP) and employs approximately two thirds of India's labour force.

VAST MARKET POTENTIAL

India's market potential is vast. There is adequate technically-trained manpower, rapid industrialisation and urbanisation, a wealth of mineral resources, extensive modernisation of transport systems, a well-distributed network of communication links and developing energy, education and health facilities. The essential substance of India's change and progress since its independence in 1947 is evident from its near self-sufficiency in clothing, medicines and several consumer products; it is also one of the largest producers of chemicals, leather goods, electronic items, textiles, engineering goods, scooters and bicycles in the world. Not surprisingly, the steel industry in India is about the same size as that of the steel industry in the UK and Italy.

1947-1991: EXCESSIVE REGULATION

From 1947 to 1991 the business environment in India was regulated to an excessive degree and the industrial approval process lacked transparency. The main objectives were to place the public sector at the commanding heights of the economy by promoting economic self-reliance, developing the small-scale sector, encouraging regional progress and ensuring that economic power was not concentrated in the private sector. The result was excessive bureaucratic control, slow, if any, technological progress, severely limited private and foreign investment, and excessive governmental spending on largely inefficient public companies, all of which led to a high-cost industry. Although there was emphasis on internal and regional urbanisation, an overprotective economic environment also led to inflation, high budgetary deficits, spiralling foreign debt, increased governmental duties and taxes, a low per capita GDP and an almost negligible increase in the industrial production index.

Until the 1980s, foreign investment was permitted only where any required technology was unavailable. Subsequently, a more liberal view was taken by the Indian Government on the policy for foreign equity holding and foreign capital, but technology was allowed only if it was state-of-the-art and not indigenously available or where the venture was predominantly export-oriented.

LIBERALISATION: AN ECONOMIC TURNING POINT

In 1991, India faced a severe economic crisis and foreign exchange reserves were at an all-time low. The country was left with little choice but to adopt a radically different economic policy. The Industrial Policy, announced on July 25 1991, encouraged a change from resource-based manufacturing to technology-intensive manufacturing and services, and investment by both the domestic and foreign private sectors. Its aim was to deregulate the economy, encourage exports, promote technological advancement, decentralise power and attract the inflow of foreign exchange. This policy was the first substantive step taken by the government in liberalising the excessive restrictions that prevailed, especially those pertaining to foreign investment, industrial licensing, restrictive trade practices, foreign technology and private sector policy.

The reforms put forward by the industrial policy were aimed at opening up the overprotected market to attract foreign investment and to accelerate the process of globalisation of the economy. It specifically sought to address and overcome the most serious impediments to India's economic development, such as inwardly-focused trade, financial uncertainties, bureaucratic delays, unemployment, a large, disorganised public sector and unattractive foreign investment policies. However, instead of absolute privatisation, the government has thus far allowed the private sector to compete with the public sector. In the long run, this should enable the private sector to take over the role of the public sector to a large extent.

The industrial policy specifically states that foreign investment is beneficial for India's industrial development and is welcome. Foreign equity investment is now considered separate from investment that basically incorporates the transfer of technology and is sought by a wide range of high-priority sectors and critical infrastructure projects, as well as export-oriented industries. The industrial policy strives to bring dynamism to the Indian economy by ensuring that investment decisions are evaluated on viable commercial considerations, by providing transparent approval processes, and by serving to eliminate delays, the underlying idea being to increase competition and to establish a market-oriented economic system.

MORE ATTRACTIVE TO FOREIGN INVESTORS

For a long time, India has been considered a country with tremendous potential for economic growth but was ignored by international investors. In recent years, however, India has gained significant ground and visibility by its radical changes in attitude, response, work culture, professionalism and specialisation in both its political and economic environments, and by using these changes to attract foreign investment. Reforms in tax, exchange regulations and trade regimes and in the financial sector have initiated a quiet economic revolution and India's foreign investment administration is as investor-friendly as that of any other emerging economy.

RAPID ECONOMIC GROWTH

Reforms have helped accelerate the growth rate immensely. After stagnating in 1991–92 and 1992–93, the Indian economy achieved a 5% growth rate in 1993–94, 6.3% in 1994–95 and 7% in 1995–96. Growth has been driven largely by exports, private domestic and foreign investments and domestic savings. In 1995-96 the industry and construction sectors registered a growth of 11.7% 1995-96 and the service sector grew by 7%. For the first time in recent years, GDP growth occurred independently of growth in the agricultural sector.

Few countries can claim such a quick and smooth recovery from so deep an economic crisis as that faced by India during the early 1970s, and again in 1991 when the balance-of-payments position was in crisis, with only two week reserves remaining in July of that year. Indian industry has since experienced a vibrant, broad-based recovery with industrial growth at 8.7% in November 1994 and with the manufacturing and capital goods sectors growing annually at an estimated 9.2% and 24.7% respectively.

To complement the industrial policy, the government continues to make internal changes as well. These include cutting subsidies and controlling unadministered spending by state governments. Undoubtedly diminished government borrowing will help to keep interest rates down. The finances of money-losing public sector companies are being closely monitored and the government has taken the initiative to privatise some of these companies. A similar evolution can be delineated in India's trade policy.

REFORMS SINCE LIBERALISATION

Since 1991, various domestic and international policies have been announced in India that enhance possibilities both for economic progress as well as make India a viable and attractive market for the foreign investor. Some of these policy developments have included:

- raising the limit for foreign direct investment (FDI) from 40% to between 50% and 74% in certain industries. Foreign companies may be allowed to buy real estate in India and develop it for certain industries and utilities. The insurance sector has been opened up to foreign investment, albeit partially. Industries such as coal and lignite, which were previously reserved for the public sector, have also been opened up for private investment, again to a limited extent. Only six items, including defence equipment, atomic energy, mineral oils, minerals specified for governmental control and use, railway transport, and arms and ammunitions that are considered sensitive and strategic, remain reserved for the public sector;
- introducing new technologies and enhancing exports in consumer goods sectors that are linked to the agricultural sector and generate employment;
- abolishing industrial licensing and regulated registration for all sectors, except 15 industries considered sensitive from the security, strategic, environmental and/or social angles;
- allowing free negotiation of terms of technology transfer for Indian and foreign companies, which are partners in a joint venture or collaboration, according to their own commercial judgment. Foreign technology agreements need not accompany foreign equity proposals;
- liberalising government policy on the import of capital goods;
- granting automatic approval to foreign technology agreements relating to high-priority industries up to a lump sum payment of Rs10m. The rate of royalty is 5% for domestic sales and 8% for exports, subject to a total payment of 8% of sales over a 10-year period from the date of the agreement or seven years from the commencement of production;
- freeing the remittance of profits abroad for ventures in all sectors with the exception of 22 controlled industries;
- allowing foreign investment in cash, capital goods or technology, there is also no minimum cash requirement;
- capital goods being freely importable except for a few items on the government's negative list;
- planning for full convertibility of the Indian rupee. The rupee is fully convertible on the trade account (import and export) but only partially convertible on the current account. The Reserve Bank of India has stated that India's liberalisation programme plans capital account convertibility to occur in stages, which will be dependent largely on fiscal consolidation and strengthening of the domestic financial system. The rupee exchange rate is no longer fixed by the government and floats freely according to the demand for and supply of foreign exchange in the market;
- opening further investment avenues for foreign institutional investors;
- reducing peak duty rates for several items, particularly in the chemical, textile, electronics, fuels and power plant equipment sectors;
- recognising the need for consultancy and advisory services, particularly in the fields of law, accountancy, environment, taxation, business and market research. The need for these services is rising and has increased particularly in the last two to three years. Several specialist foreign firms are in the process of gathering information on commercial opportunities in India. The principle of reciprocity is the guiding factor for the government while granting permission to foreign firms to allow such service setups in India;
- allowing the remittance abroad of dividends, technical fees and interest under a 'blanket' approval given by the Reserve Bank of India to a company, once its proposal is formally approved;
- allowing Indian companies to gain access to international capital markets by issuing global depository receipts and convertible bonds;
- gradually reducing licensing restrictions, particularly on the import of capital, intermediate and partially-liberalised goods;
- actively seeking foreign investment in specified priority sectors. India's main growth sectors are: government-administered industries such as power generation, oil and gas exploration, electrical equipment, oil refining, hotel and tourism, water supply, sewerage disposal, water processing, telecommunications, mining, and monitoring; and control of pollution. In the industrial sectors, investment is particularly being sought in manufacturing and commercial training, design consulting, materials-handling equipment, software,

aviation and packaging. Consumer durables, health care, sewing machine, television and radio, and beverage industries are other growth areas. In the financial sector, banking, hire purchase, insurance, housing finance and investor information are growing. In addition, the government recently identified other priority sectors for foreign investment: infrastructure (specifically, power, highways and ports), food processing, leather and leather goods, ready-made garments, chemicals and metallurgy;

- incorporating new guidelines in the government's foreign investment policy that form the basis on which the government will evaluate FDI proposals. The Industry Ministry stated in 1997 that it has no objection, in principle, to permit FDI or the establishment of 100% foreign-owned subsidiaries in non-priority industries, provided these create employment opportunities, or are in some way beneficial to the agricultural sector, contribute to foreign exchange earnings, produce world-class products, bring in distinctive brand names and new technologies, or enhance exports. Applications to set up ventures in the consumer sector would, however, be considered on a case-by-case basis. FDI would be especially welcomed in infrastructure, high-technology areas and in sectors promoting value-added items and export, provided the interests of domestic companies are not compromised. It is hoped that these guidelines will overcome the earlier system of ad hoc clearances and impart greater transparency to existing clearance procedures;
- new policy has been evolved for those multi-national companies (MNCs) which seek to set up 100% subsidiaries in addition to operating joint ventures with Indian partners. The aim of this policy is to protect the interests of shareholders of such joint ventures when their MNC partners apply to establish a wholly-owned subsidiary in the same product range as that of the joint venture. Some concerns were expressed in early 1996 by minority investors regarding the affiliates of some MNCs. It was felt that overseas parent companies would accord preference to their wholly-owned subsidiaries. Whilst retaining their affiliates and their manufacturing outfits, these parent companies would make their wholly-owned subsidiaries the marketing vehicle, thereby diminishing the prospects and advantages that could derive to the joint venture.

The government made public guidelines for approval of wholly foreign-owned subsidiaries in February 1997. According to the guidelines, the government may consider and approve proposals for 100% foreign-owned companies in the following cases:

- where only 'holding' operations are involved;
- where proprietary technology is sought to be protected, or sophisticated technology is proposed to be brought in;
- where at least 50% of production is for export purposes;
- where proposals are for consultancy services;
- where proposals are for power plants, ports, industrial townships or industrial parks.

The government has announced that investors could be granted temporary approval to set up 100% subsidiaries on the condition that they divest 26% of their holding to Indian investors or the Indian public within three to five years of the approval.

The government has clarified that wholly-owned subsidiaries will not be allowed to be paid royalties, a policy generally followed in the past but never publicly articulated. The government has, however, yet to decide the question of whether other payments, such as technology or know-how fees, or research and development fees, will be allowed instead.

CONCLUSION

According to the Indian Government's *Economic Survey Report* for 1997–98 the reform and liberalisation process has created a much improved economic situation in the country. Although the pace of future reforms and the precise form that they will take is uncertain, one thing is clear: economic reform will continue. In this context, the economic decision-making role of state governments is expected to grow and investors will have to deal more with state authorities than central authorities. The government seems to be taking deliberate and measured steps to develop a growth-focused environment, the aim being to try to accommodate diverse interests without deviating from its primary goal of poverty alleviation, social justice and social development, and to maintain India's status as a secure and attractive destination for foreign investment.

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The Cayman Islands

Sham trusts

by Naomi Lawton

The *Trusts (Amendment) (Immediate Effect and Reserved Powers) Law* 1998 (the 'Amendment') came into effect in the Cayman Islands in May 1998 and was designed to address the issue generally referred to as 'invalid testamentary dispositions' or 'sham trusts'.

The general rule (inherited from English law principles) is that where the owner of property transfers legal title to property to another, with instructions to deal with the property entirely as the owner directs and on the death of the owner to deliver the property as a gift to a third party, the person taking possession is merely an agent for the owner and not a trustee. The agency terminates on the owner's death. No interest in the property passes to the third party before the owner dies. Nor will any interest pass to the third party on the death of the owner because the disposition is regarded as testamentary and, if it was not executed in accordance with the Wills Law, is invalid.