Economic Liberalization in India and Japan's Wavering Response

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Abstract

The end of the cold war coincided with the introduction of wide-ranging economic liberalization measures in India. The Indian economy, which had operated within a narrow framework thanks to the rigid socialist philosophy, started opening up from 1991. Since then numerous measures have been adopted to remove unnecessary restrictions on the role of private enterprise in India. Similarly, for too long a time, India had pursued an economic strategy based on import substitution. But now, export-led growth has become a major thrust of India's strategy. As a result of these economic reforms, India's manufacturing industries have witnessed dramatic growth leading to the accumulation of huge foreign exchange resources. To what extent has Japan taken advantage of the prevailing favourable economic climate in India? While Japan's evaluation of India's economic prospects has been positive, it has still not tapped India's potential fully. Whereas other countries like the US and UK have gone far ahead in strengthening their economic ties, Japan is still rather wavering in its approach. To be sure, Japan was one of the earliest countries to invest in India even during the 1960s. Many of the economic surveys done by the Japanese firms have considered India as a very attractive investment destination both in the medium and long-term perspectives. Yet, for a variety of reasons, Japanese investments have not grown in an appreciable manner. The time has come for both countries to seriously examine their relations in terms of building a long-term partnership that can contribute to the stability of Asia.

Introduction

The launching of the economic liberalization programme in India in 1991 was a

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Ritsumeikan Annual Review of International Studies, 2003. ISSN 1347-8214. Vol.2, pp. 129-142

landmark development in the post-independent economic history of India. It marked a paradigm shift in the future direction of the Indian economy which had until then operated within a narrow framework predominantly governed by a state oriented socialist philosophy. The new policy had placed India on the road to free and market economy. That such a momentous decision was initiated by a government which did not enjoy the majority strength in the Indian parliament clearly underlined the urgency for the sweeping reforms that followed. Political parties belonging to both leftist and rightist hues, despite their initial misgivings, gradually tended to support the reforms. Major economic partners of India like the US, EU, Japan, and so on, looked upon the liberalization programme with great expectation. This paper focuses particular attention on Japan's response. The case of Japan is important because it has been a major contributor to India's economic development for over forty years. Indo-Japanese relations, which have witnessed their Golden Jubilee this year, have predominantly been economic in nature. A major trading partner, Japan's official development assistance (ODA) has been substantial since 1958 and the ODA inflows have made a significant contribution to India's economy in a number of sectors. Given its long history of interactions with India, it was expected that Japan's support for the liberalization programme would be translated into its enhanced presence in India's investment and trade scenario. But so far, the growth of Japan's investment and trade with India has been only nominal. The present article, which seeks to examine the reasons for Japan's wavering response, has three sections. First , it tries to briefly explain the circumstances leading to the introduction of economic reforms in India. Second, it briefly discusses the nature of the reforms. Third, it examines Japan's response.

1. Background to reforms:

Soon after the attainment of freedom in 1947, India was faced with serious challenges such as economic and industrial backwardness, poverty, illiteracy, unemployment and so on. Politically, the partition of the country created a great deal of confusion and uncertainty. Centuries of colonial rule left the country in a state of helplessness. India's leaders facing pressures from both Power blocs were very keen to avoid any undue dependence on any foreign country for its sustenance. The government had very few policy options. It adopted the principles of planned economy and import substitution in order to promote native industries and attain a degree of self-sufficiency in at least some sectors. The crux of this policy was to develop a self-sustained economy while receiving assistance from other countries whenever necessary. The role of the state in the development of the economy became central. This strategy was to some extent inevitable given the nascent state of the private sector in India at that time. The Industrial Policy of 1948 and the successive five year plans adopted by the government clearly testified to the preponderance of the state. Though this economic policy contributed to India's industrialization to some degree, it also created many problems. Large scale state-sponsored enterprises soon became inefficient and non-competitive. Excessive government spending led to mounting deficits in the budget. Targets envisaged in the plans appeared far too distant and elusive and had to be drastically modified. Further, natural disasters, regional conflicts and political instability compelled the government to deflect from its chosen goals. The economic situation was so precarious that at the beginning of the 1980s, the government had to turn to the IMF for loans and in response to its conditionalties, it had to initiate several deregulation measures. Yet the main thrust of the economic policies was still governed by the earlier socialist philosophy.

It took another few years before it became inevitable for the economy to undergo critical structural changes. The collapse of the cold war deprived India of many of the advantages it had enjoyed earlier. India could no longer count on the favourable terms of trade it had enjoyed with the Soviet Union. India's currency position suffered still more seriously with the marked increase in oil prices following the Gulf War in August 1990. Perhaps at no time in the past had the currency situation of the country reached such grim dimensions . The government was forced to mortgage its gold reserves to raise loans. It was under these circumstances that it had to approach the IMF for rescue and in return accepted several conditionalties which led to far-reaching structural changes. Sweeping measures in external, financial and public sectors meant to put the Indian economy on the road to liberalization and reform were implemented.

2. Liberalization measures:

In July 1991, a New Industrial Policy was announced and it clearly indicated the new path that the Indian economy was to traverse from then on. In particular, a major policy to deregulate and promote foreign direct investment has been in effect since then . Under the previous industrial policy regime, India discouraged foreign investment very strongly. It also put too many restrictions on domestic competition by means of licensing schemes and barriers to the entry of new companies. Under the new 1991 policy, doors were opened for easier flow of foreign investment. Thirty six fields have now been earmarked for the automatic approval for direct investment. Vital fields, which were once closed for foreign investors like mining, oil exploration, transport, telecommunication, etc, are now open to them. The private sector can now operate in all areas except some strategic ones like defence, atomic energy, etc. Licensing has almost been done away with except in a very few cases. The incentives the foreign investors now enjoy are truly impressive. Foreign equity is now granted to the extent of one hundred per cent. For instance, keeping in mind the acute shortage of power in the country, the government wants to attract foreign companies to power generation sector by offering one hundred per cent equity. Automatic approval is given within two weeks to proposals involving foreign equity up to 51per cent in thirty six high priority areas. These proposals need not be accompanied by technology transfer agreements. In order to speed up the process of clearing FDI proposals, the government also set up Foreign Investment Promotion Board. The government revised the Foreign Exchange Regulation Act (FERA) in order to remove unnecessary restrictions on foreign investors and bring more benefits to them like setting up branch offices, purchase of real estate, fund-raising, using their brand names, etc, on par with domestic investors. The earlier insistence on the inclusion of a high local content on foreign firms has also been scrapped. India also signed the Convention of the Multilateral Investment Guarantee Agency in order to provide protection to foreign investors. The government also liberalized imports by abolishing the import approval system. Tariff rates since 1991 have been appreciably lowered.[1]

One direct result of the reforms can be seen in the sustained growth of the economy in the following years. Since 1992 the GDP has maintained an annual average growth of about 6 per cent. Only in 2002-03, the GDP fell to 4.3 per cent, but in 2003-04, it is expected to be above 6 per cent.

Industrial growth following the reforms has contributed to major strides in capital formation. The contribution of the manufacturing industries under the private enterprise has been significant and this is undoubtedly due to the new buoyancy that the private sector has received thanks to the reforms. Exports have also witnessed quantum jump as a result of the growth of the manufacturing

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1. See details, Nagesh Kumar, "Liberalization and Japanese Foreign Direct Investments in India" in K.V. Kesavan (Ed) *Building a Global Partnership*, (Lancer's Books, New Delhi, 2002) pp 166-69

industries. Further there has been a steady and unprecedented growth in the accumulation of foreign exchange reserves of the country. In December 2003, the reserves constituted a whopping $96 billion.

3. Japan’s Response:

Japan, which had always entertained deep misgivings about India’s earlier inward-looking economic strategy based on import substitution, welcomed the liberalization policy. It considered that the new strategy would speed up India’s drive for modernization and open up unprecedented economic opportunities for foreign direct investment . It believed that the new economic reforms would give a boost to the utilization of vast human and technical resources in India. In order to understand how Japan has utilized the new opportunities to enhance its direct investment in India, it would be useful to have a brief look at the Figures I and II. They clearly show the cumulative approval of the Japanese investment and the actual inflow during 1991-2002 .Though the cumulative approvals amounted to $ 3.1 billion, the actual inflows amounted to $1.2 billion since there is a gestation period needed for the full realization of the approvals .The quantum of Japanese FDI has increased, but it is still small given the potential of the Indian economy. Japan ranked fourth behind the US, UK, and Mauritius. In recent years, South Korea’s investments in India are growing rapidly and may even surpass Japan’s if the current pace of Japanese FDI continues. The flow of Japanese investments is seen in such sectors like transportation (32%), telecommunication (16%), power (12%), chemicals (11%) and electrical equipment (6%). Figure III gives the details of the shares of different sectors.

Both Japan and India have also entered into several technical collaborations which account for 7% of all such collaborations in India. The sectors where Japanese technical collaborations are seen include electrical industry (26%), transportation (24%), chemicals (9%), Industrial machinery (6%) and metallurgy (5%). Figure IV and V give the details of the shares of these sectors.

It is obvious that despite the favourable climate for investment, Japan’s FDI in India has remained too small during the last ten years and does not merit any great attention. In order to understand Japan’s hesitation, it would be appropriate to have a brief look at the pattern of investment ties the two countries had prior to 1991. Japan’s overseas investments were modest during the 1960s when India accounted for one per cent. But when Japan’s FDI increased rapidly following its high economic growth, other countries attracted its attention more. During 1951-91, when Japan's overall external investment amounted to $ 386.5 billion, India's share was a meager $332 million. This was in sharp contrast to what some of the other Asian countries like Indonesia, Singapore, Malaysia, Thailand and the Philippines received from Japan. There were many reasons for closer economic interactions between Japan and the ASEAN countries. First, even during the 1960s, Japan made utmost efforts to establish lasting economic bonds with these countries. The reparations payments in the form of capital goods initially laid the basis of their mutual economic ties. These payments, spread over a fairly long period , provided Southeast Asian countries with industrial plants and capital goods at a time when they were hard pressed financial resources. Second, investment laws in these countries were quite attractive to Japanese firms. Third, almost all Southeast Asian countries received Japan's ODA on a large scale and many of them utilized it in such a way that generated avenues for Japanese FDI. This phenomenon was also noticeable in the case of China. But India, which has also been a major recipient of economic aid from Japan, failed to make such effective coordination. Fourth, Japan's investments in the ASEAN region witnessed major strides following the Plaza Accord in 1985. Japanese FDI until then had been meant essentially for ASEAN domestic markets. The rising labour cost in Japan and the rapid appreciation of Yen impelled the Japanese investors to shift many of their manufacturing bases to the ASEAN region where the labour cost was still low. The ASEAN countries themselves were in a mood to invite Japanese investors in view of the their own economic difficulties caused by the steep fall in the prices of rubber and agricultural products. There was, therefore, a basic convergence of mutual interests. However, one should make a distinction between Japanese FDI in ASEAN before and after 1985. Whereas the Japanese companies were engaged in manufacturing goods basically for the domestic markets of ASEAN countries before 1985, their post- Plaza Accord manufacture of goods was meant for overseas markets including Japan. The post-1985 period witnessed the production of highly sophisticated goods in a variety of sectors since they were meant for foreign markets. There was a pattern in the movement of Japanese FDI in that it first moved to South Korea, Taiwan and Singapore. As the labour cost rose in these countries, Japanese FDI then moved in the direction of Malaysia and China. As the cost of production loses comparative advantages, Japan will have to look elsewhere for its investment. Another point that needs to be noticed is the growing intra- regional investment within ASEAN and the combined investment of the countries within the region surpasses Japan's. Further, the emergence of

China as an economic power with a strong base in sectors like electronics, and communication and consumer appliances can pose a serious challenge to Japan. The advantages that Japan enjoyed earlier in the region may not be available in the coming years. It has to look for new alternatives with a great market potential and other advantages like low cost of labour, etc. India with a huge market should attract the Japanese investors.

3.1 India's Look East Policy:

Another factor favourable for an expanded economic framework between the two countries should be seen in the Look East policy vigorously pursued by India since 1992. It almost coincided with India's launching of the economic liberalization policy. Having been impressed by the economic dynamism of East Asian and ASEAN countries, India thought that the time had come for it to strengthen its relations with them. One direct result of this policy was that in 1994 India became a dialogue partner of ASEAN. In 1996, India joined the ASEAN Regional Forum. India's relations with the ASEAN countries since then have expanded dramatically culminating in the realization of the annual ASEAN plus One summit meetings. India also signed the treaty of amity and non-aggression with the ASEAN grouping in October 2003.

The Look East policy has also contributed to closer understanding with Japan. In August 2000, the then Japanese prime minister Mori Yoshiro made a significant visit to India and urged both countries to build a new global partnership that would address a wide spectrum of international issues like nuclear disarmament, anti-terrorism, the restructuring of the UN, maritime safety, technology transfer, environment, etc. In particular, he wanted both India and Japan to take advantage of the IT revolution in building a new partnership. The same point was reiterated by the Indian prime minister Atal Behari Vajpayee when he visited Japan in December 2001. The Joint Communique he issued with his Japanese counterpart Koizumi Junichiro on 10 December provides a comprehensive framework for the future directions of Indo-Japanese relations. Both leaders recognized that "unbounded opportunities exist especially in the area of Information and Communication Technology in which there are extraordinarily strong complementarities between Japan and India."[2] They wanted their two countries to help bridge the digital divide so that the benefits of

2. Japan-India Joint Declaration 10 December, 2001(Ministry of Foreign Affairs, Japan)

IT revolution could be shared by all.

3.2 Reasons for Japanese small presence:

The economic reforms have undoubtedly changed the business environment in India and this has been admitted by the Japanese investors also. For instance, the periodical surveys conducted by the Japan Bank of International Cooperation have consistently rated India as the second most promising destination for investment in the long term perspective among developing countries. In the medium term perspective, India has also ranked among the top six developing countries. Yet, Japanese investment in India accounts for less than 0.5 per cent of Japan's overall investment. What are the reasons for this vacillation on the part of Japan? Numerous surveys have been undertaken to elicit the opinions of the Japanese companies located in India on this question. While there is an overall appreciation of the changes brought about by the liberalization, there are still serious reservations on a number of issues. They mention several roadblocks like the lack of infrastructure facilities, labour problems, the high-tariffs levied by the government, their inability to freely import the requisite components, and so on. They also hold that the investment climate is not uniformly good throughout India and that southern states are more investment friendly than others. They further refer to the complex centre-state relations. The failure of the Enron venture in the power sector caused considerable anxieties in their minds. They also point out that business climate in India is average or less than average when compared to Malaysia, Vietnam, South Korea and Indonesia, China, Singapore, Thailand and Hong Kong which are considered more conducive for investment.[3] Figure VI gives an idea of the distribution of Japanese investment in China, Korea, Hong Kong and India during 2000-02.

3.3 Predominance of ODA in Indo-Japanese relations:

India was the first country to receive Japan's economic assistance as early as 1958 and since then bilateral relations have been centred around ODA. After mid 1980's Japan held the status of the biggest donor country to India until 1998 when India conducted the nuclear tests. As a major recipient of Japanese aid, India immensely benefited during the last over forty years. ODA has covered a

3."Investment Environment in India- A Survey of Japanese Investors" (Federation of Indian Chambers of Commerce and Industries, New Delhi, n d) wide range of sectors like power, transport, communication, port development, health, environment, preservation of cultural heritage and so on. But unlike China and ASEAN countries which maintained some balance and linkages between ODA and investment, India concentrated only on the ODA which became the core component of bilateral relations. Unfortunately when Japan suspended its ODA in May 1998 following the nuclear tests conducted by India, it seriously affected the whole gamut of bilateral interactions. It created a great deal of uncertainty in other areas like bilateral trade and investment. Normalcy was restored only in October 2001when Japan lifted its earlier suspension of ODA. India should understand that ODA is now becoming more and more controversial even within Japan. The Japanese taxpayers are very critical of the present ODA policy pursued by their government. In response, the government has also cut down the financial allocations for ODA in recent years. Further, it also wants to apply certain conditionalties before providing ODA to any country. It seems that Japan may cut down the overall size of its ODA in the coming years and see that it is given to countries with 'tangible benefits' in return for Japan.[4] Japan has decided to reduce its economic aid to China in the fiscal 2004-5 and increase instead its financial contribution to the reconstruction of Iraq. There is also a serious debate within the ruling coalition on the question of providing continued financial aid to China. There are serious doubts as to whether China needs assistance at the present stage when its economy has made remarkable progress. Keeping in mind the current trends affecting Japan's ODA, it is time for India to shift its attention to other avenues like trade and investment.

3.4 Trade:

Trade is an important area of bilateral economic interaction. But it has always been marked by a glaring asymmetry. Whereas Japan is the third biggest economic trading partner of India, India does not even account for one per cent of Japan's global trade. In 2001-02, bilateral trade amounted to $ 3.5 billion and this pales into insignificance when one compares Japan's huge trade with China and the ASEAN countries. Japan does not depend exclusively on India for any important commodity. Marine products form the main item of India's exports accounting for 28%, followed by gems and jewellery (26%), textiles product (12%) and iron ore and minerals (10%). Other items include garments, tea, software,

4. See Kazuto Tsuji, "The Changing Perspectives of Japan's ODA: Implications for India" in K.V. Kesavan (Ed) Building A Global Partnership, pp 135-43

leather goods, etc. Given the scale of India's economy and its natural resources, the size of its exports is much too small. In order to expand its exports, India has to carefully study the changing needs of the Japanese market and take appropriate measures to respond to them.

India- Japan Trade 1996-2002
(In Million dollars)

Year	Exports to Japan	Imports from Japan	Total
1996-97	2005.8	2187.4	4193.2
1997-98	1898.4	2144.9	4043.3
1998-99	1650.8	2384.4	4035.2
1999-00	1703.0	2355.0	4048.0
2000-01	1972.2	1820.8	3623.0
2001-02	1495.2	2048.0	3543.2

Source: Government of India, New Delhi.

In recent years, India has done extremely well in the service sector. In particular, it has emerged as a strong global player in the IT sector. It has a vast pool of English speaking man power numbering more than 200,000 software professionals. Foreign IT companies from the US find it much more economical to locate their overseas offices in India because of the availability of inexpensive, but very competent professionals. The American IT firms have gone in a big way to outsource most of their activities in India in order to cut down their expenditures. In India, Bangalore, Chennai, Hyderabad and Pune have become major IT centres. The software export has now become one of the major components of India's external trade. It constitutes about one tenth of India's total exports, but its share in the global software trade is still very small. If we look at the destinations of India's software exports, it becomes clear that the US accounts for more than 60%. Japan' share is only about 6%. Considering the vast needs of Japan, this figure is incredibly small. When former prime minister Mori Yoshiro visited India in August 2000 ,he focused particular attention on this aspect. Starting his visit from Bangalore, a major IT centre, he called upon both countries to make coordinated efforts to increase their economic and business interactions. He wanted both countries to widen the range of their commercial relations in order to lay the foundation for a global partnership .He promised to invite ten thousand Indian IT experts to Japan with a view to starting the process. But ,as of now, both Japan and India are nowhere near the goal of utilizing the full potential of the IT. The number of Indian software professionals in Japan is only around 800. Though the IT offers unlimited opportunities, both countries have to work out well-planned targets and the methods to reach them. For instance, the Japanese outsourcing in the IT field amounts to more than $ 50 billion annually. But still India has not taken serious efforts to attract the Japanese investment. It should be remembered that China is also making rapid headway in the IT field and will pose a serious challenge in the coming years. China is the largest producer of computers and peripherals in the world. In the last several years, China has attracted foreign IT giants by giving real incentives by means of tax concessions, as well as facilities to import liberally the requisite equipment, components and spare parts.. The functioning of the special economic zones has been very effective in the flow foreign investment and technology. India which has also set up such zones could perhaps draw some lessons from the Chinese experience.[5]

FigureI : TOTAL YEARWISE APPROVALS & INFLOW FIGURE OF JAPANESE INVESTMENT IN INDIA

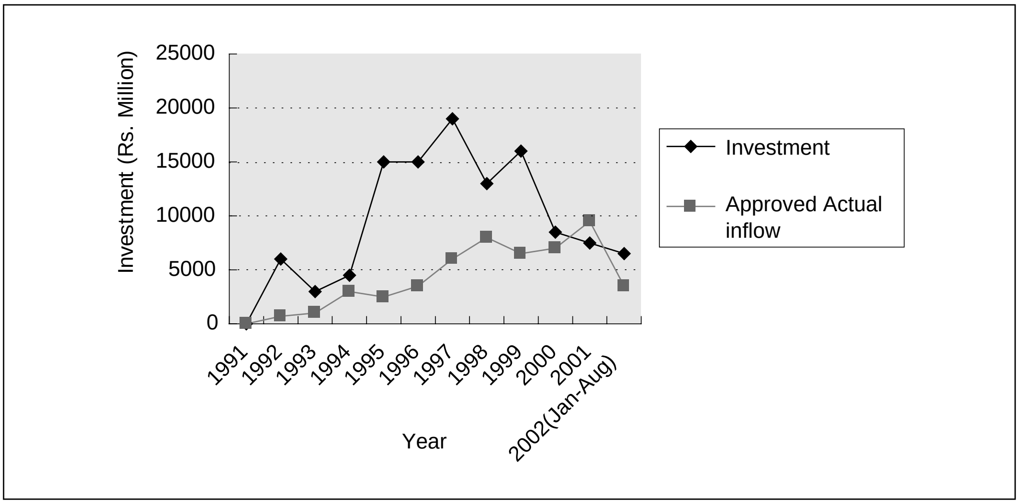
(Amount in US$ millions)

YEAR	APPROVALS	INFLOWS
1991	21.5	2.3
1992	233.2	27.4
1993	84.0	26.4
1994	127.8	87.9
1995	482.3	72.3
1996	425.2	86.0
1997	554.7	168.9
1998	344.5	183.3
1999	379.7	151.3
2000	192.5	158.5
2001	151.6	198
2002	154.34 (upto 31 Dec 2002)	64.06 (Jan - Aug 2002)
TOTAL	**3.1 (US $bn)**	**1251.3 (US$ mn)**

Source: Confederation of Indian Industry, New Delhi

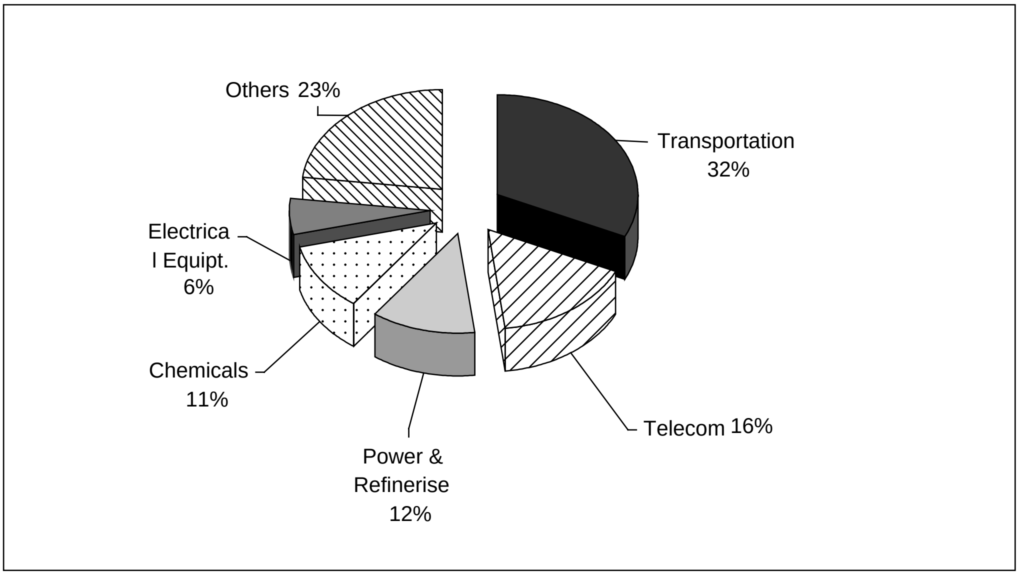
5. S. Majumdar, "FDI: Hi China, Excuse me India", Business Line (Hindu Group of Publications, Madras) 12 April, 2002.

Figure II: Japanese Investment in India (1991-2002)



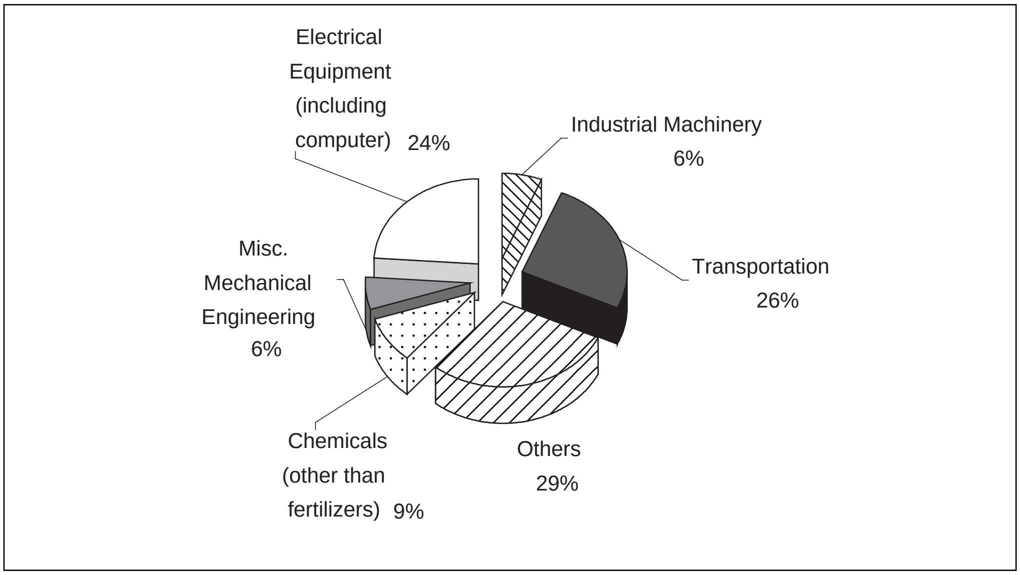
Source: Ministry of Industry, GOI, New Delhi

Figure III : Sectoral Distribution of Japanese Investment (1991-2002)



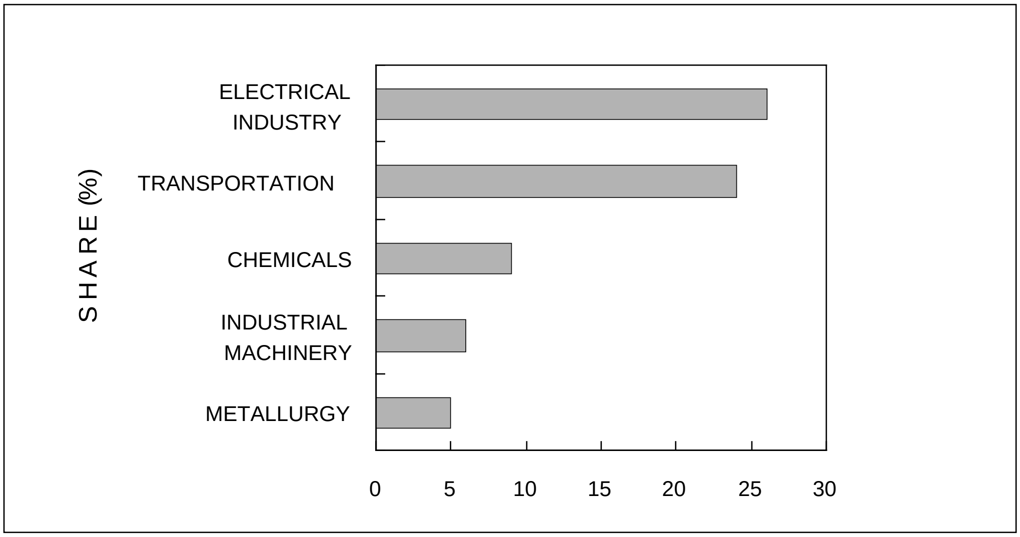
Source: SIA Newsletter, GOI, New Delhi

Figure IV : AREAS OF JAPANESE TECHNICAL COLLABORATIONS



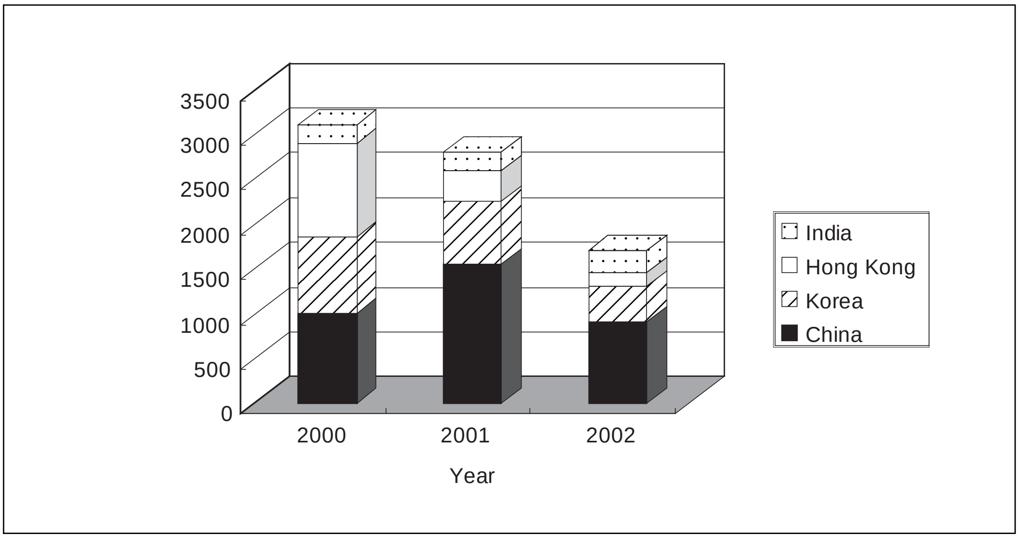
Source: SIA Newsletter, GOI, New Delhi

Figure V : Technology Transfer from Japan (1991-2002)



Source: SIA Newsletter, GOI, New Delhi.

Figure VI: JAPANESE OUTWARD DIRECT INVESTMENT IN INDIA & FAR EAST ASIA (Japanese Yen 100 million)



Source: FICCI, New Delhi.