UNIT 10 CORPORATE STRATEGY AND FOREIGN DIRECT INVESTMENT

Structure

10.0 OBJECTIVES

After studying this unit you should be able to :

- explain the meaning, strategy and rationale of multinational corporations
- discuss the ratlonal of foreign direct investment
- analyse corporate strategy regarding joint ventures and global expansion
- throw light on Indian regulation of foreign direct investment and FERA and FEMA

10.1 INTRODUCTION

As you know the companies and customers have become international. Therefore, the number of investors has been increasing. They are buying the shares of multinational corporations. Multinational corporations try to create the value of their shareholders by investing in the projects abroad which have positive net present value. In order to earn return on their projects, multinational corporations must be able to transfer abroad their sources of domestic competitive advantage. For this, they have to plan a strategy for global expansion and joint venture which they undertake abaord.

In this unit, you will learn about the meaning and strategy of multinational corporations and rationale of foreign direct investment. You will also learn about the corporate strategy joint ventures and global expansion and Indian regulation and guidelines of foreign direct investment and foreign exchange regulation — FERA and FEMA.

10.2 MEANING AND THEORY OF MULTINATIONAL CORPORATIONS

The history of multinational corporations (MNCs) can be traced to ancient times when India was a leading player in international commerce.

According to Kautilya's Arthasastra, hundred per cent quality control on exports, as well as imports, was the watch word in that regime. That can be described as the first stage in the development of multinational corporations. The second stage can be identified with the appearance of commercial revolution in England, alongwith the craze for colonisation on the part of several European countries, some five hundred years back (around 1500 A.D.) in the wake of the then time-honoured doctrine of Mercantilism. It implied augmentation in the stock of precious metals like gold and silver through favourable balances of trade. The East India Company belonged to that genus, though it soon turned political.

The third stage, most relevant to current international business, is a Post-Industrial revolution phenomenon which has blossomed largely in the twentieth century. The approximate take-off dates were, according to Rostow, 1783-1802 for Great Britain, 1830-60 for France, 1843-60 for the United States, 1850-73 for Germany, 1878-1900 for Japan, and 1890-1914 for Russia. In this game, India (which is said to have entered the take-off stage in 1952 alongwith China) and many other developing countries have been largely at the receiving end. MNCs, having developed countries as their "home", have often extended their industrial activity through their subsidiaries to "host" countries of the developing world. Of late, some MNCs of Indian origin, too, have tried to replicate their manufacturing and service activities in other countries, not only the less-developed ones, but even some of those which are deemed to be advanced. The following five basic criteria were laid down for a multinational company by Mr. Jacques G Maisonrouge, President of IBM World Trade Corporation (a subsidiary of International Business Machines Corporation) :

1) It must do business in many countries. I don't think that a company doing business in two or three countries can be considered multinational; it must be in many countries that are in different stages of economic development.
2) It must have foreign subsidiaries with the same R & D, manufacturing, sales services, and so on, that a true national entity has. You can't prepare general managers if you have only a sales organisation.
3) There should be nationals running those local companies; they understand the local scene better than anybody else, and this helps promote good citizenship.
4) There must be a multinational head quarter, staffed with people coming from different countries, so one nationality does not dominate the organisation too much.
5) There must be multinational stock ownership the stock must be owned by people in different countries.

Mr. Maisonrouge concedes that, in perfect fulfilment of these criteria, there is no truly multinational company. So, a more pragmatic definition has been offered by Professor Om Prakash of Jaipur, as follows (at the fourth world congress of economists, Budapest) : "MNC is a corporate undertaking whose industrial operations are based in more than two countries and whose decision-making process is based on an overall strategy." The new slogan is "Think Global, Act Local". This supports the first criterion that the MNC must bring within its ambit many countries that are in different stages of economic development, so as to subserve a high degree of economic complementarity. Again, the overall complexion of the MNC must not appear to be the replica of any one nationality. Moreover, mere selling agencies do not amount to multinational corporations which must have sufficiently strong 'production base' of a comparable character in a number of countries.

Professor C.P. Kindleberger of MIT, in his lectures on direct investment, had used the term International Corporation "which has no country to which it owes more loyalty than any other to which it feels completely at home." In an ideal situation, this would lead to the Theory of Equi-distance amongst various countries covered by the International (Multinational) Corporation. The term Transational Corporation (TNC) has been in vogue so far as some international official documents are concerned. In letter, any corporation which transcends a national boundary can be called a TNC. But, in spirit, a TNC is much more than a Binational Corporation (BNC) whose activities are confined to just two countries, such as "India and Nepal" or "USA and Canada". According to UNCTAD World Investment Report 1995, the global sales of 250,000 foreign afliates of 40,000 TNCs exceeded $5,000 billion. They controlled over 80 percent of world trade and 90 percent of patents worldwide. The sales of the four biggest TNC exceeded the GDP of all African countries.

According to Fortune (American) 1997 list of 500 Global Corporations, about one-third (162) had USA as their home country, while roughly one-fourth (126) had their origin in Japan. France (42), Germany (41) and Britain (34) put together accounted for another (close to) one-fourth of the Fortune 500 (1997) list. As many as 405 (over 80 per cent) of these MNCs belonged to these five countries.Amongst the top ten, no less than six were of Japanese origin, while three were Americans and only one European. In the 1997 list, the first three positions were held by General Motors (USA), Ford (USA), and Mitsui

(Japan). The Japanese MNCs had been at the height of their glory in the Fortune 500 of 1995 when they numbered 149, close to USA's record of 151, the top four MNCs being all from Japan. By 1997, American MNCs were able to recover much of their lost ground. Both in 1995 and 1997, Royal Dutch Shell was the only MNC of European origin appearing amongst the top ten. The annual turnover of USA's General Motors in 1996 (basis for its first rank in the 1997 Fortune 500 list) amounted to $168 billion (Rs. 5,88,000 crore), over ten times. The gross turnover of Indian Oil Corporation, the leading Indian major finding a place amongst Global 500. Earlier, on the basis of 1994 revenues, the Japanese MNC Mitsubishi had occupied the first rank, in the Fortune 500 list of 1995, with an annual turnover of $176 billion.

10.3 STRATEGIES OF MULTINATIONAL CORPORATIONS

What are the vital strategies adopted by MNCs? And, on what theories are these strategies based? Let us start with the strategy of PYRAMIDING which aims at maximal clout with minimal investment. In legal as well as commercial parlance, it implies the use of holding company device. Legally, a holding company (holding corporation) is one which holds major ownership interest (51 per cent) in another company which is called the subsidiary company (subsidiary corporation).

Commercially (in an operational sense), multinational corporation may be able to reap the major benefits of holding company control even with small minority stakes. In this process, the number of (directly or indirectly) controlled companies grows by geometric progression. Thus if, in the first stage, the primary holding company controls three intermediate holding companies, the latter, in their turn (second stage), would be able to control another nine companies, presumming that three companies are controlled by each intermediate holding company. The following figure (Fig. 10.1) illustrates the position.

The Strategy of
PYRAMIDING

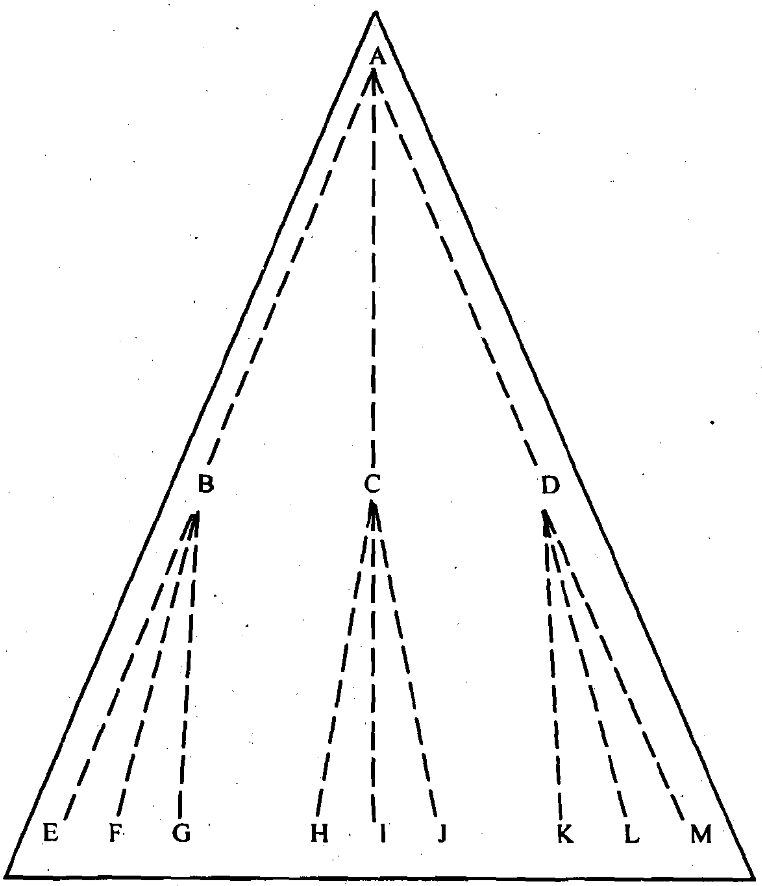

Fig. 10.1 : Here 'A' is Apex Holding Company (vertex of the Multinational Group). B, C and D are Intermediate Holding Companies (say, in America, Europe and Japan) E, F, G, H, I, J, K, L and M are subsidiary companies.

In all, there are 13 companies in the Multinational Group. as depicted in Fig. 10.1. If the pyramidal chain were prolonged further (next stage) in the same ratio, there would be an addition of 27 (sub) subsidiary companies, carrying the total tally of the Multinational Group to 40. However, please do not think that there is any sanctity attached to a ratio of three. It could be two, four, five or any other number. If this ratio is taken to be five, there would be 31 companies at the third stage and 156 companies at the fourth stage in this chain. Again, please remember that different ratios may operate at different stages, and even within the same stage. For example, the Apex Multinational may hold only two companies while one of these Intermediate Holding Companies controls ten (and another such company controls five) subsidiary companies. Thus, in all, there may be 18 companies in the Multinational Group.

Coming back to Fig. 10.1 let us try to find out the amount of investment which the Apex Multinational would be required to make for controlling the other (one dozen) companies in the Group. For the sake of convenience in calculation, let us assume that the nine subsidiaries (third stage) have a share capital of $100 million each. So, each one of the three intermediate holding companies would be called upon to make an investment of $153 (51×3) million, presuming that shares are sold at par, and that 51 per cent share holding is necessary for the purpose. Keeping in view other needs of these three companies (second stage), the share capital of each such company may be taken to be $ 300 million. The Apex Multinational would now need $ 459 million to (directly) control these three companies (with the same two assumptions) having an aggregate share capital of $ 900 million. Within the orbit of indirect control would fall the remaining nine companies with an aggregate share capital of $ 900 million. Taking of total view of second and third stages, the Apex Multinational is able to control share capital amounting to $ 1,800 million with an investment of just about one-fourth ($459 million). So to say, the MNC's controlling power is about four times at the third stage, eight times at the fifth stage, sixteen times at the sixth stage, and so on. The pyramidal magic works much faster if a company can be controlled with a stake much less than 51 per cent, say, by a consolidated block of 26 or even lower percentage. However, there may be an in-built element of uncertainty in such operational arrangements.

Synergy may be the theory often guiding the strategy of pyramiding, as also the strategies of mergers and acquisitions. That is, the combined value of companies, integrated in any of these ways, is supposed to be higher than the arithmetic total of the values of those companies (say, 100 million +100 million may be equal to more than 200 million, may be, 300 million). Even if this is not so precisely, there may be a general belief that "big is beautiful" or "more powerful".

However, this may be more of myth than reality. As Elvin Toffler records in his Powershift (1992) there is mounting evidence that giant firms are too slow and maladaptive for today's high-speed business world; not only has small business provided most of the 20 million jobs added in the U.S. economy since 1977, it has provided most of the innovation. The biggest companies were reported to be most profitable, on the basis of return on equity, in only four out of 67 industries covered by a Business Week study.

Yet, a few success stories and the psychosis of numbers continue to stimulate (cross-frontier) friendly, unfriendly and even hostile take-overs, mixed marriages, mergers, amalgamations, acquisitions, joint ventures and other manifestations of strategic integration. In the public sector, some of the recent strategies have symbolised diverstiture, disinvestment, privatisation and all that. Here the charm of socio-political gains (such as winning the vote banks of trade unions through employee stock ownership) may dominate over economic considerations as such.

Transfer pricing is another well-known strategy adopted by MNCs. It aims at minimising tax (and other burdens) and maximising profit (and other benefits). Suppose that Asea Brown Bover (ABB), with its roots in Sweden and Switzerland, is operating in India to supply wagons to Indian Railways. If, at a certain point of time, the marginal rates of income tax (corporate tax) are 45 per cent in Sweden, 35 per cent in India, and 25 per cent in Switzerland, ABB's strategy would be to disclose maximum profit in Switzerland and minimum profit in Sweden, with India as a midway zone where profits can be allowed to appear at a medium level. How can this be achieved?

ABB (India) can import some components from ABB (Switzerland) at an inflated cost. If these components constitute 50 per cent of the total cost, a 20 per cent escalation therein would push up the total cost in India by 10 per cent. In case the erstwhile margin of profit (on cost) was 30 per cent (say, Rs. 300 crore on an overall contract cost of Rs. 1,000 crore), the same is now reduced to 20 per cent (say, Rs. 200 crore on a contract cost of Rs. 1,000 crore). Thus the ABB (MNC) pays a tax of Rs. 70 crore (assuming a flat rate) in India as against Rs. 105 crore which would have been the tax liability in India on a profit of Rs. 300 crore. The profit of Rs. 100 crore transferred to Switzerland (through the strategy of transfer pricing) would attract a tax liability of only Rs. 25 crore in that country. Thus (as between India and Switzerland) there may be a net gain of Rs. 10 crore. However, this gain may stand reduced, or more than counter balanced, by the burden of customs duties on components imported from Switzerland. There may be other constraints too impinging against the benefits of transfer pricing. For example, Indian Railways, or the Government of India, may not permit the import of such components; they may insist on a high degree of indigenisation. Or, supplies from abroad may be impeded by transport bottle necks, high costs and similar risks. Other constraints may include vulnerability of foreign exchange rates, interest rate fluctuations, and changes in governmental regulations (as also their interpretations) at both ends -- India and Switzerland.

How about transferring taxable income from ABB (Sweden) to ABB (Switzerland) or to ABB (India)? High-paid managers may be transferred from Switzerland and India to Sweden; and (or), in a reverse process, low-paid managers may be transferred from Sweden to Switzerland and India. This strategy of transfer pricing will swell profits of ABB (Switzerland) and ABB (India), while understating the level of profits at ABB (Sweden) which is subject to the highest rate of taxation amongst the three countries (units) under reference.

Alternatively, ABB (Switzerland) and ABB (India) may import raw material (say, Swedish steel or iron) from ABB (Sweden) at low cost. As such, the profits declared under the Swedish regime will be pushed down, while those under the Swiss and Indian regimes would be overstated. In fine, the overall (global) tax liability of ABB (MNC) could, thus, be minimised. But the feasibility of such strategies, whether with regard to the transfer of managerial services or raw materials, may be seriously jeopardised if the country losing tax revenue (Sweden in this case) mounts an offensive to upset the apple-cart (say, through blanket bans, or punitive taxation). Moreover, transport bottle necks, high costs and other risks may impede the flow of raw materials. Again, with respect to the transfer of managerial services, technical and human limitations may turn out to be formidable constraints. Even though multinational managers are supposed to have developed a highly-adjustable global culture, some of then may, still, be averse to inter-country transfers. For example, a manager (with family) brought up in India's cultural traditions may feel uncomfortable in the premissive environment of Sweden (and vice versa). Family circumstances, state of health, food habits, language and communication problems may be other factors responsible for hindering human mobility. In fact, all these put together lead to built-in incompatibility of attitudes; these, at times, may create serious emotional conflict throughout the multinational group of companies.

Two broad conclusions seem to emerge from this discussion. First, the MNC has to decide whether the game of transfer pricing is worth the candle, i.e., whether the likely gain outweighs the likely risk. Second, in view of the constant change in economic (and other) variables, it may not be feasible to sustain a long-term strategy of transfer pricing. At any rate, it may call for review from time to time so as to be in tune with the instant situation.

Check Your Progress A

1 An Apex Multinational needs 50 per cent ownership interest in each one of its four Intermediate holding companies who, in their turn, can control 16 subsidiary companies with a stake of 25 percent in each one. If the Apex Multinational holds shares of the face value of $ 800 million, and all transactions have taken place at par, what is the aggregate parvalue of the share capital of 20 companies controlled by it, directly and indirectly? Presume that intermediate holding companies use only half of their capital for controlling subsidiary companies.

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2 Matsushita of Japan has set up a vertically integrated manufacturing facility for electrical equipment in Sri Lanka (30%), India (50%) and Nepal (20%). The overall profitability position is expected to be as follows (Rupees of these three countries being treated at par):

Year	Production Cost (Rupees) Crore	Loss(–) Profit (+) Break-even (00) Rupees/Crore
1	50	–10
2	100	–5
3	150	00
4	200	+15
5	250	+50

Nepal has offered a tax holiday for five years without any facility of the carry-forward of losses. India permits carry-forward of losses without any tax holiday; there is a flat rate of 30 per cent tax on profits. Sri Lanka imposes 20 per cent tax on profits without any facility regarding carry-forward of losses.

You are required to work out overall tax liability of Matsushita (MNC) for the first five years :

i) on the basis of proportions of production cost appertaining to the three countries (Sri Lanka, India and (Nepal);

ii) if all the profits and losses are declared in Sri Lanka alone;

iii) if all the profits and losses are declared in India alone;

iv) if all the profits and losses are declared in Nepal alone, but the Government of that country withdraws the tax holiday after four years, and imposes a tax of 25 per cent on the profits earned by Matsushita.

10.4 MEANING AND RATIONALE OF FOREIGN DIRECT INVESTMENT

Foreign Direct Investment (FDI) often involves the setting up of subsidiaries in foreign countries for the domestic production of commodities/services which previously were imported, say, from the parent company (primary holding company/apex multinational). It can be distinguished from Portfolio Investment (PI) as follows :

FDI	PI
a) Investment in physical assets	a) Investment in financial assets
b) Tends to be long-term	b) Tends to be short-term
c) Difficult to withdraw	c) Easy to withdraw
d) Does not tend to be speculative	d) Tends to be speculative
e) Expectation of technology transfer	e) No expectation of technology transfer
f) Direct impact on employment of labour and wages	f) No direct impact on employment of labour and wages
g) Abiding interest in management	g) Fleeting interest in management

The rationale of FDI may be based, inter alia, on the following considerations :

i) Conquest of emerging markets with sizeable population living in the midst of identifiable gaps in development;

ii) Economies of large-scale operation emanating from technological explosion;

iii) Lower level of economic efficiency in host countries;

iv) Import barriers in host countries emanating from the spirit of Swadeshi (patriotism), high customs duties or blanket bans;

v) Saving in time and transport costs;

vi) Shortage/high cost of labour in capital exporting countries and cheap/abundant labour in capital importing countries;

vii) Surplus capital in rich countries (emanating from favourable balance of payments, high per capita income or any other factors) and shortage of capital/foreign exchange resources in poor countries;

viii) Lower rates of interest/return in developed countries and higher rates of interest (guaranteed) return in developing countries;

(ix) Internationalisation of patents (intellectual property rights) and cross flows of technology;

x) Influencing the physical, political, socio-economic and cultural milieu of capital importing countries;

xi) Creating formal, informal and brand monopolies in a global context;

xii) Promoting the optimal utilization of physical, human, financial and other resources in a global context for alleviation of poverty;

xiii) Strengthening socio-economic infrastructure such or health services, roads, transport, communication and education; and

xiv) Maintaining ecological balance, controlling pollution (both physical and intellectual), and promoting peace, harmony and good neighbourly relations.

The conquest of emerging markets comes to the centre-stage as developed regions (say, North America, Europe and Japan) begin to experience some kind of a saturation point, so that FDI in populous but less developed countries of Asia, Africa and South America is looked upon not only as an opportunity, but also as a matter of necessity by foreign investors. Their operations, though expanded, may not, necessarily, be more efficient than those of domestic players. Again, while many foreign players may succeed in overcoming import barriers (whether created by government or people's psychological preference for domestic good/services), economic efficiency alone may not provide sufficient condition for survival or success. Some of the (relatively) less efficient MNCs in economic terms may come to command clout on account of political geographical, racial and other exterior considerations. While transport costs, labour costs, time and interest costs are important, the real life story (success or failure) may be different from the economic rationale as anticipated. In fact, a less efficient foreign player may have greater chance of getting guaranteed return and such other benefits from the government and business doyens in a host country. Again, many foreign investors may be more interested in building up monopolies through cultural conquest than in optimal utilisation of resources, poverty alleviation or soundness of socio-economic overheads. So, the adoption of a village by a foreign investor may not, in spite of pompous protestations, be such a positive or even innocent affair; not infrequently, the outcome may be negative, such as making poor villagers used to cosmetic life and dependent on the products of Multinational Corporation. In the ultimate analysis, far from restoring the original ecological balance, they might have, in course of time, added substantially to the nefarious level of domestic pollution. Yet, it is held out in many quarters that, but for the support through FDI, several of the developing countries would have lagged far behind in the instant race for economic development.

China can be said to be the most attractive destination for net private capital flows, as we find that its volume rose from $1,732 million in 1980 to $44,339 million in 1995, when her population stood at 1,200 million. By way of contrast, net private capital flows rose just from $ 868 million in 1980 to $ 3,592 million in 1995 when India, with a population of

929 million, was a close second to China in the matter of manpower. Net private capital flows to Pakistan rose from $ 230 million in 1980 to $ 1,443 million in 1995. On per capita basis, these flows were higher than those in India with a population more than seven times that of Pakistan. For Sri Lanka, Bangladesh and Nepal, these flows were static, negligible or negative. Countries witnessing a high water mark of net private flows include Brazil, Mexico, Malaysia, Indonesia, Thailand, Argentina, Czech Republic, Poland, Philippines and Chile. However, in every case, these flows cannot be taken to be a sign of strength; financial credc3ises, like the one of 1997-98, have severely gripped some of these countries.

In India, there has been serious disparity between "Approvals" and "Actual Inflows" of FDI as indicated below:

Foreign Direct Investment

Year	Approvals US $ million	Actual Inflows US $ million	Actual Inflows as Percentage of approvals
1991	325	155	47.7
1992	1781	233	13.1
1993	3559	574	16.1
1994	4332	958	22.1
1995	11245	2100	18.7
1996	11142	2383	21.4
1997 (up to November)	14858	3105	20.9
Total (1991 to November 1997)	47,242	9,508	20.1

A large proportion of FDI flow to India has been routed through Mauritius, partly because of the double taxation treaty between the two countries. USA, Germany and Netherlands have been other important sources.

To which sectors of the economy should the flow of FDI be encouraged, discouraged or left to itself? Three broad approaches can be identified in this regard. First, the conventional outlook is to encourage FDI in the core (hi-tech) sector like power (in particular, non-conventional energy), oil exploration, telecommunications, water resources and bio-technology. On the other side of this coin, FDI may be discouraged (or left to itself) in food processing and other consumer goods, where domestic industry's state-of-the-art is quite venerable, and there is not much point in importing foreign technology. The oft-quoted example is that of "Uncle Chips" priced at Rs. 15 for a packet of 50 grams (working out to Rs. 300 per kilogram, as against comparable domestic product priced at, say, Rs. 50 per kilogram).

Second, there is the contra-conventional (minority) view that FDI should be discouraged in the core sector if powerful MNCs are to be prevented from acquiring over-riding politico-economic power over the host country. Once these foreign interests get entrenched in the key areas of that country's economy, a near-permanent state of subservience may be created. A national government trying to get rid of domineering foreign investors may, itself, get toppled down. So, if at all, FDI may be permitted only in the (light) consumer goods sector only, so that these foreign investors can be packed off when the national government so signals. Moreover, if and when these foreign investors choose to withdraw from the scene, the economy of the host country may not be subjected to any big jerk. However, in practice, even such a stipulation may not be quite feasible. Some MNCs in the consumer sector may come to acquire greater clout than those in the core sector, specially when a host country's economy is largely dependent on a single consumer produce (product) like tea or watches.

Third, it is the type of approach being adopted by India since 1991, more particularly in the wake of nuclear tests conducted in May 1998, and followed by freezing of foreign aid and the imposition of sanctions at the instance of some developed countries. Here, with a few exceptions (like the controversial domestic sector of civil aviation), foreign investment is welcome in almost any (core or consumer) sector. For example, FDI has been permitted even for the manufacturing of pens, pencils and other stationery items normally reserved for the cottage land small scale industries.

10.5 CORPORATE STRATEGY, JOINT VENTURES AND GLOBAL EXPANSION

Corporate strategy can be defined as a proposed course of action or sequence of actions designed to have a far-reaching effect on an organisation's ability to achieve its leading objective(s). It is often used in the context of a company's plan of action that causes it to allocate its scarce resources (specially finance) over time "to get from where it is to where it wants to go". "Strategy" has been depicted as the base of a cold triangle (three hard elements), superimposed by four soft elements, in the well-known "SEVEN S's MODEL" given below (Fig. 10.2)

THE SEVEN S's MODEL

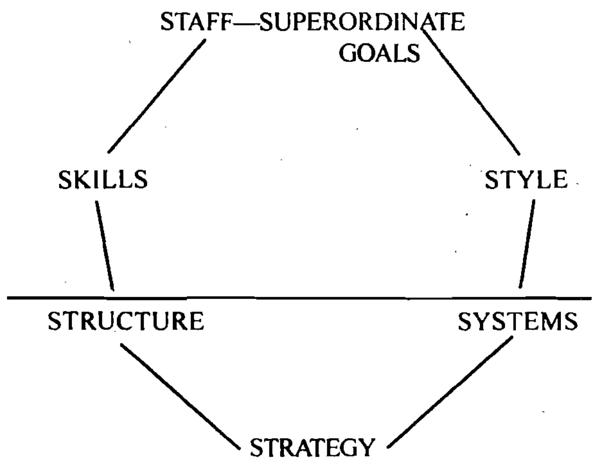

Fig. 10.2

Corporate strategy, in association with structure (organisation chart) and systems (procedures), is supposed to achieve superordinate goals (significant objectives/guiding concepts) through skills (distinctive capabilities), staff (personnel) and style (organisational culture). The model assumes, though this may not be so in many real life situations that strategy, structure and systems tend to be more rigid (less amenable to change) than skills, staff, style and even super ordinate goals. Actually, in certain situations, particularly in India, staff may turn out to be the most stubborn element for management to be able to effect any meaningful change.

What can be the superordinate goals for an organisation? Dhirubhai Ambani's Reliance Industries Limited (RIL) may have an entry into Fortune (USA)'s Global 500 as the top most goal. Once it is achieved, say at 475th rank, the goal may be revised to, say, 400th, 300th and 200th position in that honours list. For General Motors Corporation, the challenge may be to maintain its first rank in Fortune 500; for, in the post, it had lost to some of the Japanese companies. Likewise, other superordinate goals may relate to dominant position (on the basis of asset size, market share, export performance, profitability, price, cost, employee strength, innovation, or some other criterion) in any industry, country or region. The pendulum of goals may move in opposite directions from time to time, e.g., diversification versus reduction in product range, vertical integration versus horizontal combination, fattening versus slimming exercises.

Strategic alliances often take the form of joint ventures (JVs). There has been phenomenal growth of triangular JVs involving companies or parts of companies in Japan, the United States and Europe. According to Kenichi Ohmae, head of the McKinsey office in Tokyo, "trilateral consortia" are being formed in nearly every area of leading edge industry including biotechnology, computers, robots, semiconductors, jet engines, nuclear power, carbon fibres, and other new materials. Olivetti, the Italian firm, has concentrated on "networking of companies" based on alliances, partnerships, agreements, research and technical cooperation. It, alone, had entered into some fifty such arrangements by 1990 or so. Maruti Udyog Limited (MUL) has been a prominent joint venture between the Government of India and Suzuki Motor Corporation of Japan. A few years back, the majority stake of the Government of India was watered down to 50 (49.74) per cent, whereas the Japanese partner (Suzuki) was allowed to enhance its shareholding to an equivalent level. Thus, MUL ceased to be Government company, and controversy raged over the key appointment(s) of chairman/managing director. Suzuki carried the matter to an international court of arbitration. However, the issue was amicably settled in June 1998 through the good offices of Ms. Sikander Bakht, Industries Minister in the Government of India. No doubt, quite a few JVs tend to be rather fragile.

Global expansion can be looked at from several stand points. The first basis may be percentage annual growth of consumption and production. During 1994-95, real consumer spending was ahead of industrial production in Europe, Japan, Latin America and USA. By way of contrast, consumption fell behind production in all these regions during 1995-97. This was the position depicted by Asian Developing countries both during 1994-95 and 1995-97. Indonesia, the Philippines, Malaysia, South Korea and Thailand were the five economies most affected by the Asian financial crisis at this stage. In 1996, these countries had received total net capital inflows of $ 93 billion. By way of striking contrast, they suffered a net outflow of $ 12 billion during 1997, while net private capital outflows to large emerging economies (globally) had actually gone up from $ 202 billion in 1996 to $ 212 billion in 1997. Latin America (45%) was the most attractive destination, followed by Europe (25%), Asia/Pacific (23%) and Africa/Middle East (07%).

Competitive efficiency could be taken as the second yardstick of global expansion. According to the World Competitive Year Book (1998), the USA is installed strongly in its position as the most competitive nation in the world, while Japan has suffered the most serious setback, falling from 9th rank in 1997 to 18th rank in 1998.

In a list of 46, India stood as low as 41st in both the years. Russia ranked still lower at 46th position. China improved her rank from 27th in 1997 to 24th in 1998, while France fell from 19th to 21st position. Germany remained stable at 14th rank in both the years. The first twelve ranks were held by the following countries in 1998 (their relative position in 1997 being stated within brackets) :

1. United States (1)
2. Singapore (2)
3. Hong Kong (3)
4. The Netherlands (6)
5. Finland (4)
6. Norway (5)
7. Switzerland (7)
8. Denmark (8)
9. Luxembourg (12)
10. Canada (10)
11. Ireland (15)
12. Britain (11)

The third criterion of global expansion may be based on a specific industry, such as automobiles, where several MNCs at the top have been rubbing their shoulders. The USA, with a population of about 268 million, witnessed sales of some fifteen million cars and light trucks in 1997. Thus one out of every 18 residents of the United States (or one out of every four/five families of five/four members each) is, on an average, going in for a new automobile every year. The first four players (General Motors, 31.4%; Ford, 24.9%, Chryster, 16.1%; and Toyota, 7.6%) controlled 80 per cent of the U.S. market, as worked out on the basis of November 1997 sales. Smaller market shares were claimed by Honda

(6.3%), Nissan (4.3%), Mazda (1.2%), Sabaru (1.2%), and Mitsubishi (1.1%). Thus, the Japanese miracle, which had upset the apple-cart of the American market some two decades back, was on the wane. The remaining of the first one dozen players were Mercedes (1.1%), Volkswagen (0.9%) and BMW (0.8%). On a miniature scale, the German automobile offensive appeared to be on the ascendancy, with Mercedes claiming a 67% spurt in the US market (the highest amongst the first twelve) in November 1997. Volkswagen, too, presented a 13% increase, as against only 10% in the case of General Motors, while Ford had experienced a marginal decline in the number of vehicles sold, and Mitsubishi had lost 10%. In fine, global expansion tends to be a zigzag affair.

10.6 INDIAN REGULATION OF FOREIGN DIRECT INVESTMENT AND GUIDELINES

The role of foreign investment in the Indian economy was very limited prior to 1991. During five years 1986-90, FDI approvals figured at Rs. 900 crore (or, Rs. 180 crore per year, on an average). Under this restrictive regime, the normal ceiling for foreign investment was 40 per cent of the total equity capital. A higher percentage could be considered in priority industries if the technology was sophisticated and not available in the country, or if the (joint) venture was largely export-oriented.

In the wake of economic reforms, the Government established a more liberalised foreign investment regime as part of the new industrial policy announced in July 1991. As against case-by-case consideration, and that too within the normal ceiling of 40 per cent, provision was made for automatic approval of FDI up to 51 per cent in 34 specified (high priority, capital intensive and high technology) industries. However, two conditions were attached to this approval : first, that the foreign exchange involved in importing capital goods is covered by foreign equity; and second, that outflows on account of dividend payments are balanced by export earnings over a period of seven years from the commencement of production. Foreign technology agreements were also liberalised for the 34 industries. Firms were left free to negotiate the terms of technology transfer on the basis of their own commercial judgement, and without the need for prior Government approval for hiring foreign technicians and for foreign testing of indigenously developed technologies. To promote professional marketing activities, foreign equity holding up to 51 per cent was permitted for trading companies as well. A Foreign Investment Promotion Board (FIPB) was set up to look into large foreign investment projects where more than 51 per cent foreign equity might be permitted.

In course of time, further relaxations were granted. On April13, 1992, India signed the Multilateral Investment Guarantee Agency Protocol for protection of foreign investments. The dividend-balancing condition attached to foreign investments upto 51 per cent was no longer applied except for consumer goods industries. Existing companies with foreign equity could, subject to certain prescribed guidelines, raise it to 51 per cent. Non-resident Indians (NRIs) were permitted to invest up to 100 per cent equity in high-priority industries (with repatriability of capital and income), export/trading houses, hospitals, hotels and tourism-related industries. FDI was also allowed in exploration, production and refining of oil, as also in marketing of gas. Captive coal mines could also be owned and run by private investors in power. Foreign companies were allowed to use their trade marks on domestic sales.

In December 1996, the Reserve Bank of India allowed automatic approval of FDI up to 74% in nine categories :

i) Electricity generation and transmission;

ii) Non-conventional energy generation and transmission;

iii) Maintenance of roads, bridges, ports, harbours, runways, waterways, tunnels, pipelines, industrial and power plants;

iv) Pipeline transport except POL (petroleum, oil and lubricants) and gas;

v) Water transport;

vi) Cold storage and warehousing for agricultural products;

vii) Mining services, except for gold, silver and precious stones, and exploration and production of POL and gas;

viii) Manufacturing of iron ore pallets, pig iron, semi-finished iron and steel, and manufacturing of navigational, meteorological, geophysical, oceanographic, hydrological and ultrasounding instruments; and

ix) Items based on solar energy.

Recently, the insurance sector has been included in automatic approval list. Along with that, the list of industries eligible for automatic approval of foreign equity up to 51 per cent was further expanded so that some fifty industries were covered under this category.The new areas, inter alia, include health and medical services, and technical testing research and development services.

In January 1997, the Government of India announced the first-ever guidelines for FDI to ensure expeditious approval of foreign investment in areas not covered under automatic approval. Priority areas included :

a) Infrastructure;

b) Export potential

c) Large-scale employment potential, particularly for rural areas;

d) Items having linkages with the farm sector;

e) Social sector projects like hospitals, health care and medicines; and

f) Proposals that lead to induction of technology and infusion of capital.

However, certain sectoral ceilings were retained : 20 per cent in the banking sector (40 per cent for NRIs); 24 per cent in small scale industries; 40 per cent in domestic airlines (100 per cent for NRIs); 49 per cent in telecommunications; 50 per cent in mining (excluding gold; silver, diamonds and precious stones); and 51 per cent in non-banking financial companies and drugs. Foreign equity could go up to 100 per cent in petroleum, power, roads, parts, tourism and venture capital funds. The FIPB could also allow 100 per cent foreign equity in those cases where the foreign company had expressed inability to find a suitable Indian joint venture partner, subject to the condition that the foreign investor would divest at least 26 per cent of the equity (so that the ceiling for the foreign partner would be 74 per cent) in favour of Indian parties within three to five years. The guidelines of January 1997 also allowed foreign companies to set up 100 per cent subsidiaries on the basis of the following criteria :

1) Where only holding operation is involved, and all downstream investments are to be carried out need prior approval;

2) Where proprietory technology is sought to be protected, or sophisticated technology is south to be brought in;

3) Where at least 50 per cent of production is exported;

4) Where there are consultancy projects; and

5) Where there are projects in power, ports and industrial towns/estates.

"FDI free for all" emerged as the watchword in the wake of the freezing of foreign aid and the imposition of economic sanctions, imposed by the USA and some other developed countries, following the nuclear tests conducted by India on May 11 and 13, 1998. New doors sought to be opened (or existing doors sought to be widened) in respect of foreign investment (room by room) included inter alia :

i) FDI in housing and real estate (urban affairs);

ii) Encouraging 100 per cent FDI in recombinant DNA technology-based units, also strengthening patent regime to help FDI inflow;

iii) Making water resources more attractive for FDI inflow;

iv) Across the board 100 per cent automatic FDI in non-conventionall energy (welcome, say, up to Rs. 1,500 crore limit), removing 74 per cent cap;

v) Liberalising FDI policy in coal sector to attract investment and technology; and

vi) Raising cap on non-SSI food products to 74 per cent.

On 30th August 2000, the Government opened more gates to foreign investors in the new economy. Following are high lights of the policy change :

1) 100% FDI allowed on automatic route in internet, telecom infrastructure providers, e-mail, voice mail.

2) No sectoral FDI caps in manufacturing units set up in SEZs (special economic zones)

3) Off shore VCFs, companies allowed to invest in Indian venture capitalists and corporates.

4) 1-2% royalty payment on foreign brand names, trade marks allowed.

5) 5-8% royalty payment permitted to parent foreign companies by their wholly owned subsidiaries operating in India.

6) Telecom department corporatisation complete, Bharat Sanchar Nigam Ltd. formed.

10.7 FOREIGN EXCHANGE REGULATION : FERA AND FEMA

You learnt about FDI and its rationale. Let us now study about the foreign exchange regulation in India. The first foreign exchange regulation Act in India was enacted as a temporary measure in 1947, but was placed on statutory book in 1957. In the light of the experience gained, the entry of forieign capital in the form of branches and concerns with substantial non-resident interest in them and the employment of foreigners in India the Foreign Exchange Regulation Act (FERA) 1973 was enacted on the recommendation of 47th report of Law Commission. The proceedings under FERA are quasi-criminal.A Directorate of Enforcement was constituted under the Act. The RBI is empowered to authorise any person to deal in foreign exchange or appoint foreign currency money changers. The Directorate has the power to call for information, to arrest, to search suspected persons and premises and to examine persons. Except in case of import and export of certain currency and bullion, the penalty under the Act is five times the amount or value involved.

The FERA 1973, was reviewed in 1993 and a new Act called Foreign Exchange Management Act (FEMA) 1999 (enforced w.e.f. 1.6.2000) was enacted. FEMA was enacted because significant developments have taken place such as substantial increase in India's foreign exchange resources, growth in foreign trade, rationalisation of tariffs, current account covertibility, libralisation of India investment abroad, increased access to external commercial borrowings by Indian Corporates and participation of foreign institutional investors in Indian Stock markets. The objective of the Act is to facilitate external trade and payment and to promote the orderly development and maintenance of foreign exchange market in India.

The salient features of the Act are :

1) Cases already in courts under FERA shall be governed by FERA and not under this Act.

2) Appellate Board under FERA has been dissolved and replaced by Appellate Tribunal and Special Director (appeals).

3) Every Adjudicating Authority now has the powers of a civil court. The defaulters under the Act shall be liable to civil imprisonment.

4) The penalty is thrice the sum involved or upto two lakh rupees where amount is not quantifiable. Further penalty of Rs. 5000 for everyday if contravention of the Act contines.

5) Reserve Bank of India has been given more powers for management of foreign exchange. RBI can issue directions or inspect authorised persons.

Check Your Progress B

1 What do you mean by foreign direct investment?

....

....

2 Differentiate between foreign direct investment and portfolio investment.

....

....

3 Tick the correct alternative on the following :

i) All binational corporations (BNCs) are transnational corporation (TNCs), but all TNCs are not BNCs.

ii) In June 1998, Maruti Udyog Limited (MUL) was a Government company.

iii) Foreign direct investment (FDI) is made in financial assets.

iv) Portfolio investment made by foreign institutional investors (FIIs) tends to be short-term.

v) Mitsubishi of Japan occupied the first rank in the Fortune 500 list of 1995.

vi) The annual turnover of USA's General Motors in 1996 (basis for its first rank in the 1997 Fortune 500 list) was over hundred times the gross turnover of Indian Oil Corporation.

vii) Royal Dutch Shell was the biggest European MNC in the Fortune 500 list of 1995 and 1997.

viii) The MNC tries to transfer costly inputs to the country with the lowest rate of tax.

ix) Sugar is core sector industry.

x) Net private capital flow to China in 1995 was more than ten times the figure flowing to India.

10.8 LET US SUM UP

MNC is a corporate undertaking whose industrial operations are based in more than two countries and whose decision-making process is based on an overall strategy". However, Mr. Jacques G. Maisonrouged feels that the multinational company must operate in many (not just two orthree) countries that are in different stages of economic development. He also lays down four other rigid conditions, conceding ultimtely that there is no truly multinational company providing overall fulfilment of his five criteria. Professor C.P. Kindleberger prefers to use the term "international corporation", while some UN agencies have chosen to talk of "transnational corporations". Amongst the Global 500 (Fortune, USA, 1997), over 80 per cent multinational corporations had their origin in just five countries (USA, Japan, France, Germany and Britain).

The principal strategies adopted by multinational corporation include pyramiding, mergers and acquisitions (guided by the theory of synergy), and transfer pricing (guided by the motives of maximising profits and minimising taxes/other liabilities in the global context). However, in view of the constant change in economic and other variables, every strategy may call for review from time to time.

FDI involves investment in physical assets for production of commodities/services in the host country. It tends to be long-term and is difficult to withdraw (unlike portfolio investment, involving mere buying and selling of securities which tends to be speculative). Again, FDI involves abiding interest in management, expectation of technology transfer, and direct impact on employment of labour. The rationale of FDI lies, inter alia, in the conquest of emerging markets, utilisation of cheap labour in capital-deficient countries, internationalisation of patents, appropriation of augmented profits through monopolistic control and/or sophisticated technology, and creation of socio-politico-economic clout over less-developed regions.

China can be said to be the most attractive destination for net private capital flows. Other countries, prominent on this score, include Brazil, Nexico, Malaysia, Indonesia, Thailand, Argentina, Crech Republic, Poland, Philippines and Chile. The financial crisis of 1997-98 severely gripped some of these countries, which witnessed large-scale outflow of foreign capital. In India actual inflows of FDI between 1991 and November 1997 ($9.5 billion) were only about 20 per cent of FDI approvals ($47.2 billion). A large proportion of FDI flow to India has been routed through Mauritius. USA, Germany and Netherlands have been other important sources.

Corporate strategy can be defined as a proposed course of action or sequence of actions designed to have a far-reaching effect on the organisation's ability to achieve its leading objective(s). It is often used in the context of allocation of scarce resources (like finance) over time. Strategic alliances often take the form of joint ventures (JVs). Maruti Udyog Limited (MUL) has been a prominent joint venture between the Government of India and Suzuki Motor Corporation of Japan.A top-level controversy regarding the choice of Chairman/MD was amicably resolved in June 1998.

Under the restrictive regime, prior to 1991, the normal ceiling for foreign investment in India was 40 per cent of the total equity capital. In July 1991, automatic approval of FDI up to 51 per cent was permitted in specified (high priority, capital intensive and high technology) industries.A Foreign Investment Promotion Board (FIPB) was set up to look into projects where more than 51 per cent foreign equity might be permitted. In December 1996, the RBI allowed automatic approval of FDI upto 74 per cent in nine categories. In January 1997, the Government of India announced the first-ever guidelines for FDI to expedite decisions in areas not covered under automatic approval. While certain sectoral ceilings were retained, these guidelines permitted foreign companies subsidiaries on the basis of certain criteria. "FDI free for all" emerged as the watchword in the wake of the freezing of foreign aid and the imposition of economic sanctions at the instance of some developed countries, following the nuclear tests conducted by India on May 11 and 13, 1998. FDI in housing and real estate (urban affairs) and (100 per cent) foreign investment in recombinant DNA technology (along with strengthening of patent regime to help FDI inflow) are some of the newer dimensions being brought into focus. In August 2000, the Governmnet of India made further concessing and relaxation to attract FDI. The Foriegn Exchange Regulation Act (FERA) was reviewed in 1993 and a new act called Foreign Exchange Management Act (1999) was enacted to facilitate external trade and payament and to promote the development and maintenance of foreign exchange market in India.

10.9 KEY WORDS

Acquisition : One company "Taking over" another company either completely or partly through controlling ownership interest.

Amalgamation : When two (or more) companies combine and agree to operate under a third (or different) name.

Automatic approval : Where approval is granted without any case-by-case scrutiny.

Binational Corporation (BNC) : Whose operations are confined to two countries.

Captive mines : In-house mines intended to provide raw material to a company (or group's) own plants.

Core sector : Central or most important sector, such as infrastructure, on which the development of other sectors is based.

Divestiture : Giving up ownership interest.

Dividend balancing condition : A condition that outflows to foreign countries on account of dividend payments would be balanced (fully covered) by export earnings of an enterprise established in this country with investment inflows from abroad.

Ecological balance : Natural adjustment between living things in relation to their surroundings/environment.

Economic sanctions : Restrictions imposed by a country, or international agency, on aid, investment, trade or other commercial relationships with another country.

Emerging markets : Newly-discovered or growing centres of consumption, specially in developing countries.

Equity : Ownership interest usually represented by stocks or shares not bearing any fixed interest obligation.

Financial assets : Shares, securities or receivables indicating entitlement to money or ownership interest.

Foreign direct investment (FDI) : Investment used for domestic production in another country.

Fortune 500 : The list of top 500 Global Corporations (companies) published annually in the USA by Fortune magazine.

Government Company : A company where ownership interest of the Government (Central/State) is 51 per cent or more in terms of the Companies Act, 1956.

Holding company : A company which holds controlling interest (51 per cent or more in legal parlance; but, may be any smaller solid block in commercial parlance) in another company (subsidiary).

Home country : The country of origin of a multinational.

Host country : The country to which a multinational goes for making investment and extending its operations abroad.

Infrastructure : The basic inner structure (like transport and communication) on which other developmental activities are dependent.

Innovation : Something new put into practice commercially or, otherwise, effectively.

Intellectual Property Rights (IPRs) : Legal protection of inventions or other creative work through patents, copyrights, trade marks and other system of exclusive recognition, usually for some specified period.

Intermediate holding company : A holding company which, itself, is controlled by another holding company.

International corporation : A corporation operating in a number of countries with equal loyalty to all; another name for multinational corporation.

Joint venture: Sharing of ownership interest and other working arrangements between two (or more) companies (or other operating units), whether belonging to the same country or to different countries.

Merger : A complete combination between two (or more) companies, so that no new company is set up, while one of the existing companies takes over all the operations of the other company (or companies); absorption is another name for merger (while the term amalgamation, too, is used interchangeably, though somewhat inaccurately, in common parlance).

Multinational Corporation (MNC) : A corporate undertaking whose industrial operating are based in more than two countries and whose decision making process is based on an overall strategy.

Networking : Complex system of inter connection.

Non-resident Indians (NRIs) : People of Indian origin settled in foreign countries.

Physical assets : Machines and other assets used directly in the process of production.

Portfolio investment : Acquiring financial assets like shares and securities (without any direct involvement in the process of production), an activity often undertaken by both domestic and foreign financial institutions.

Primary holding company : A company which controls another company (or companies) but which, itself, is not controlled by any other company; it stands at the head (apex).

Pyramiding : A pyramid (triangle) like structure designed to extend the sphere of control of an apex institution through a set of holding companies and subsidiaries.

R & D : Research and Development (an index of the comparability of the levels of production/operation attained by various companies).

Strategy : A proposed course of action or sequence of actions designed to have a far-reaching effect on an organisation's ability to achieve its leading objective(s); it is often used for the allocation of scarce resources (specially finance) over time.

Subsidiary company : A company controlled by another (holding) company.

Superordinate goals : Objectives of higher grade, status or importance.

Synergy : Where the combined value of integrated companies is higher than the arithmatic total of the values of those companies.

Transfer Pricing : Technique of pricing inputs/products between holding companies and subsidiaries with a view to maximising profit.

Transnational corporations (TNCs) : Corporations or companies whose operations extend beyond national boundaries; another name for multinational corporations (Multinational Corporation).

10.10 ANSWERS TO CHECK YOUR PROGRESS

A) 1 $ 4,800 million

2 i) Rs. 13.90 crore, ii) Rs. 13 crore, iii) Rs. 15 crore, iv) Rs. 12.50 crore

B) 3 i) True, ii) False, iii) False, iv) True, v) True, vi) False, vii) Ture, viii) False, ix) False, x) True

10.11 TERMINAL QUESTIONS/EXERCISES

1 Identify principal stages in the development of Multinational Corporation.

2 a) Briefly enumerate the five criteria for a truly multinational company. Also indicate, with concise arguments,

b) the most important criterion; and

c) the least important criterion.

3 Can a binational corporation be called transnational corporation ? Explain clearly.

4 Distinguish between 'Primary Holding Company' and 'Intermediate Holding Company'.

5 How does pyramiding lead to the expansion of a multinational group? How would you interpret the size (height and breadth) of a pyramid?

6 What is the difference between 'Amalgamation' and 'Merger'?

7 Explain the technique of transfer pricing through an illustration (original or imaginary case study) of your own.

8 What is the most important rationale of Foreign Direct Investment? What is its greatest danger ?

9 What kind of corporate strategy should transnational group apply in respect of the following four categories of enterprises ?

a) High profits with high growth;

b) High profits with low growth;

c) Low profits with high growth;

d) Low profits with low growth;

10 Critically examine the attitude of the Government of India toward FDI enflow since 1991. What kind of a policy would you suggest to meet economic sanctions imposed after the nuclear tests of May 1998?