Infrastructure Economics
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Module – 06
Lecture - 23
FDI and FII in Infrastructure

In this presentation, we will discuss that how FDI and FII in Infrastructure is again one of the issue in the development of infrastructure. And also how this particular foreign assistance is required when we are having large demand of infrastructure and the conditions to fulfill those demand as soon as possible.

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Let me begin with the brief outline of this presentation, we will discuss in brief what is basically the foreign direct investment. We will also discuss what is institutional investment, foreign institutional investment, then I will try to establish the link between the FDI in infrastructure and again FII in infrastructure. And then, we will discuss little bit about what is basically capital account convertibility and it is role in infrastructure development. Let me start with what is basically the foreign direct investment.

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Foreign Direct Investment

- Foreign Direct Investment (FDI) is a category of international investment that reflects the objective of a resident in one economy (the direct investor) obtaining a lasting interest in an enterprise resident in another economy (the direct investment enterprise).
- The lasting interest implies the existence of a long-term relationship between the direct investor and the direct investment enterprise, and a significant degree of influence by the investor on the management of the enterprise.
- A direct investment relationship is established when the direct investor has acquired 10 percent or more of the ordinary shares or voting power of an enterprise abroad (IMF's Balance of Payments Manual, BPM5).

FDI is one of the most, today one can say that FDI is the most controversial and most dividable topic all over the world. Especially in developing country and least developed countries, where when the multinational corporations are investing their fund and FDI is coming directly in the production business, there are so many uncertainties, there are so many questions in the public mind.

And it is indeed important to understand, what is basically the FDI and how it is going to influence the production and how it is going to really create uncertainties and whether those questions and uncertainties are really existing in the world or it is just the fear of the public. So, FDI is basically a category of international investment that reflects the objective of a resident in one economy, obtaining a lasting interest in an enterprise, resident in another economy.

So, FDI is basically the investment which flow from one country to other country and if a country is receiving that investment that is basically the FDI in flow. But, the moment a country is basically not having that investment, somehow the investment is going back from the economy and that is not basically in flow, but it is the out flow of the economy. Lasting interest implies the existence of a long time relationship between the direct investor and the direct investment enterprise.

So, why the investor will come? The investor will come, because certain interest of that investor and that interest is, the interest in terms of producing directly in certain enterprises. And a significant degree of influence by the investor on the management of

the enterprise is always seen, it depends on what percentage of FDI is coming in that particular sector. If government is allowing 100 percent FDI is particular sector, the entire decisions will be taken by that particular investor.

Because, when the investor is the bulk investor, when investor is the full investor then they will not allow varieties of other divergence in the policy decisions, they will try to influence the enterprises, management and completely try to have their own influence. But, if the investor is in a very small percentage, suppose if it is 20 percent, 15 percent, 10 percent, 7 percent, then in that case the investor is basically a partial investor, not the full investor, not the final investor.

But, the other local investors are basically taking care of the entire management of the enterprises. In that case, for an investor is not going to influence the decision of the local industries or the domestic industries, because they are not really the bigger partner, they are basically the small partner. So, direct investment relationship is established when the direct investor has acquired 10 percent or more of the ordinary shares or voting power of an enterprise abroad. This is the IMF's Balance of Payments Manuals discussion that if it is more than 10 percent, then certainly it is not the ordinary share, but the relationship is really established within the investor and the enterprises.

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Foreign Institutional Investment

- Foreign Institutional Investment (FII) means investment by an institution established or incorporated outside a country, which proposes to make investment in the securities of that country.
- FII includes insurance companies, pension funds, mutual funds, foreign central banks, commercial banks, university funds, charitable trusts, foundations etc

Coming back to the discussion on another aspect of investment and that is another part of the investment that is for institutional investment, which is not directly coming to the country. But it is through the different indirect way and it means that investment by an

institution established or incorporated outside a country, which proposes to make investment in the securities of that country. FII is not really the direct investment, but it is an indirect investment through the established institution of that particular country, which provide the security of investment on a particular investor. And that includes the investment in insurance companies, pension funds, mutual funds, foreign central banks, commercial banks, university funds, charitable funds and different foundations.

So, it is not the investment, which basically comes and directly influence the production process. But, it is through the different institutions which countries establishing to get the investment in the form of different funds and shares and ultimately that type of investment is not the investment, which directly start producing the things, but it is indirectly influencing the production process.

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The foreign institutional investments as we have discussed that includes pension funds, mutual funds, investment trust, banks, insurance companies, foreign central banks, foreign government agencies, wealth funds, international multilateral organization agencies, university funds and varieties of other serving public interest, such as charitable trust, foundations and in governments. So, these are the broad category of foreign institutional investment. Now, going back to the linkage between the FDI in infrastructure, investment in infrastructure has seen a continuous surge since 2000, including both domestic as well as the foreign investments.

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FDI in Infrastructure

- Investment in Infrastructure has seen a continuous surge since 2000 including both domestic as well as foreign investments
- According to UNCTAD, Developing world has a share of 65% of world project investments by value while its share in number of projects accounted for 51% over the past decade
- Within developing and transition regions, the largest inward FDI stocks in infrastructure in 2010 were in Asia, largely in transport, storage and communications
- Share of Infrastructure in total FDI (2010) :
  - Kenya-31%
  - Morocco- 35%
  - Pakistan-24%
  - Philippines-14%

A recent study by the UNCTAD shows that developing world has a share 65 percent of the world projects investment by value, while it is share in number of projects accounted for 51 percent over the past decades. Within developing and transition regions, the largest inward FDI stocks in infrastructure in 2010 were in Asia and that was basically in the field of transport, storage and communication. If one can see some of the countries as an example, the share of infrastructure in total FDI in 2010 in Kenya was 31 percent, Morocco 35 percent, Pakistan 24 percent and Philippines 14 percent.

We will see one of the indicator that how a country is really getting the part of FDI in infrastructure. We will have a separate discussion on FDI in India also especially in infrastructure, but let me also discuss some other points. This is one of the graph which includes the FDI investment in infrastructure.

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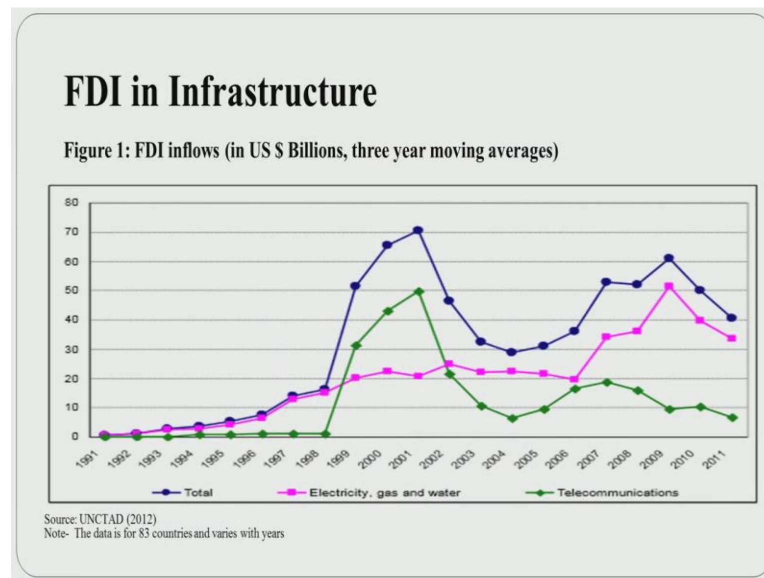

The green line shows the investment in telecommunication, while the blue line is the total investment and the other line is electricity gas and water, investment in electricity gas and water. We are finding here the largest investment and this statistics includes the investment in around 83 countries of the world, this is the UNCTAD data which includes the FDI inflow in infrastructure. And we find out that especially in telecommunication, there was a peak period of investment in total of 83 countries and that investment was huge between after 1988 to 2002.

Still we find out that there are certain investment going on in telecommunication, but there is declining trend in investment in recent years. While in case of electricity gas and water, we are finding that during the period when the FDI investment in telecommunication was on peak, there is also shares of investment in electricity, water and gas, but at the same time the current rate of investment in water, gas and electricity is much higher than the current rate of investment in telecommunication infrastructure.

So, in total we find out that because of the peak period of investment in telecommunication, the total infrastructure shown on in the blue color here, the graph shows the highest level of infrastructure development, especially in telecommunication after 1998 to 2002 or the peak period is 2001. But, at the same time there is a drop because of the drop in the telecommunication sector. So, telecommunication is undoubtedly in this example one of the major area of investment and whenever telecommunication has dropped, we find out that compare to telecommunication the investment in gas, water and electricity is less.

But, the recent trends shows that after 2006, the recent trends shows that the investment in electricity, gas and water is much higher than the investment in telecommunication. Now, India as an example, one of the reformed economy, which we have discussed in the previous presentation.

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FDI in India: Allowed Sectors

FDI is allowed in the following sectors

- Airports
  - i.) Greenfield Projects-100% (automatic)
  - ii.) Existing Projects-100% (automatic-74%)
- Industrial Parks-100% (automatic)
- Telecomm Services-100% (automatic-49%)
- Railway Infrastructure-100% (automatic)
- Construction-development projects-100% (automatic)
- Exploration activities of oil and natural gas-100% (automatic)
- Banking
  - i.) Private Sector-74% (automatic-49%)
  - ii.) Public Sector-20% (government)

We can find out that how FDI in India is allowed different sectors, in case of airports in the Greenfield projects it is 100 percent, Greenfield projects are those projects in which no facility, no infrastructure is established before. But, the existing projects are those projects which has previously developed some infrastructure. So, in that case only 74 percent FDI is allowed, but in case of the new airports coming up or the complete new infrastructure is being developed in that case 100 percent investment is required.

So, entire in case industrial parks 100 percent, telecommunication 49 percent by automatic route, railway 100 percent, telecommunication services, India can also allow 100 percent investment in telecommunication. But, by automatic route only 49 percent, for rest of the investment, investor has to take permission from the government. Railway infrastructure 100 percent, construction development projects 100 percent, exploration activities of oil and natural gas 100 percent, private sector banking 74 percent, public sector 20 percent.

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FDI in India: Prohibited Sectors

FDI is prohibited in the following sectors

1. Lottery Business
2. Gambling and Betting (including casinos)
3. Chit Funds
4. Nidhi Company
5. Trading in Transferable Development Rights (TDRs)
6. Real Estate Business or Construction of Farm House
7. Manufacturing of Cigars/Cigarettes/tobacco
8. Activities/Sectors not open to Private Sector Investment:
   i.) Atomic Energy
   ii.) Railway Operations

And compared to these, there are certain private sector, where government is not really allowing the foreign direct investment, such as lottery business, gambling and casinos, chit funds. Nidhi company, trading in transferable development rights, real estate business or construction of farm house, manufacturing of cigars, cigarettes and tobacco, activities, sectors not open to private sectors are basically atomic energy and railway operation.

So, it is still be find out that there are certain areas, where India in not allowing any in foreign direct investment compared to the areas, which we have this develop, such as the airports, railway, telecommunication, construction development and exploration activities of natural gas and the banking and industrial park, where FDI is allowed.

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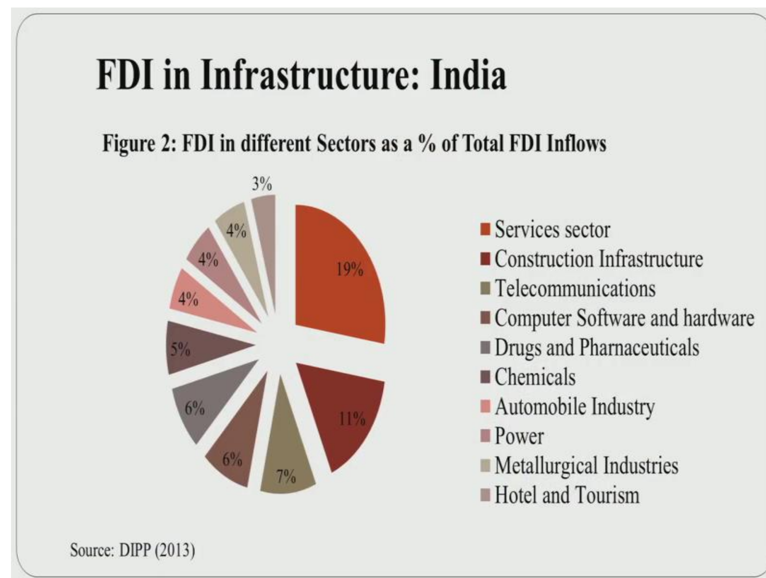

Let me also discuss briefly that what percentage of shares FDI in different sectors as percentage of total FDI inflow is available in this particular diagram and we find out that the service sector and construction in infrastructure are the leaders as first and second and telecommunication is the third one, computer software hardware is a fourth one, drug and pharmaceuticals and chemical sector is the fifth one. But, if one can see the power at the same time telecommunication India is not really having a large share of FDI coming up, because of the previous cases of FDI in power sector, investors are still not really convinced that whether you should go for investment in power sector or not.

So, majority of service sectors such as banking, insurance and other sectors we are having some percentage of investment. But, the construction infrastructure and telecommunication are not really the one which can really give India a better future in infrastructure. So, India lacks in infrastructure investment especially in power and other sectors which is more important for India to achieve.

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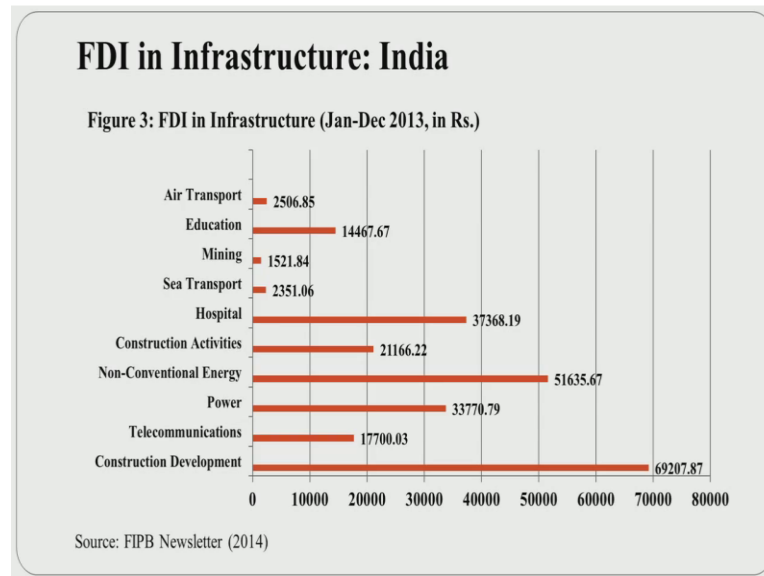

One can also see here, the FDI in infrastructure in 2013 where the air transport sector has the first largest in FDI in infrastructure, air transport sector has not the highest, but the highest infrastructure sector is the non conventional energy sector and then we have the hospital and power sector as a part of infrastructure investment. We do have construction development as one of the largest in terms of infrastructure FDI in infrastructure.

So, we do not have as much FDI available in telecommunication as it was available in the construction development in 2013. So, the trends of infrastructure investment shows that it is not the FDI in infrastructure is not as per the need and the possibilities of getting in infrastructure by India, but as per the investors need, as per the investor requirement, not as per the countries requirement.

So, we need investment in power, but the major investment is in the construction development, we need investment in telecommunication, but the investment in telecommunication is very less, it is almost half of the power FDI investment in 2013.

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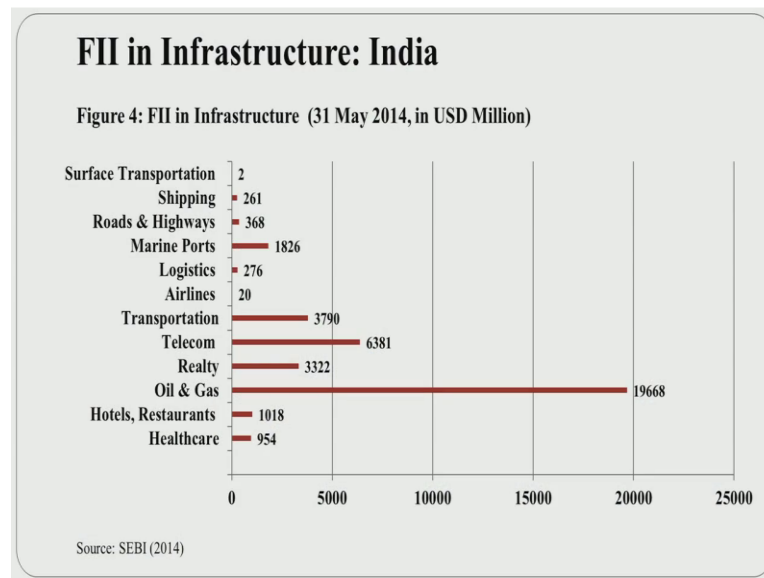

So, these indicators are not good indicators, in case of FII Foreign Institutional in Infrastructure sector the data from the SEBI, Security Exchange Board of India we found that the majority of the foreign institutional investment is received in the oil and gas sector then we have the second for most important sector to receive FII is the telecoms sector and transportation sector, but other sectors such as shipping, surface transport, marine ports and health care, hotel, restaurants in these sectors the institutional investment are not really having a very impressive results.

Let me also discuss briefly that how this controversy of full convertibility and capital account is linked with the foreign institutional investment and how the foreign institutional investment FII is again further link with the infrastructure development. So, what is basically capital account convertibility, full convertibility is basically when the capitals are received through the institutional sources like FII.

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Capital Account Convertibility (CAC)

What is CAC ?

- Freedom to convert local financial assets into foreign ones at market-determined exchange rates
- Leads to free exchange of currency at lower rates and an unrestricted mobility of capital
- Beneficial for a country because inflow of foreign investment increases
- The flip side, though, is that it could destabilise an economy due to massive capital flows in and out of the country
- India has full convertibility of rupee in the current account, but has limited convertibility on capital account

If countries are having convertibility on capital account, then whatever investment is available in a country, the investors are secure that investment will, any time will be convertible and investor can go back from the economy. India has not allowed the full convertibility on the capital account. Capital account are those account in which we have the calculation of the investments and varieties of capitals which is having the inflow and outflow in an economy.

Current account includes the export and import and other transactions and India had full convertibility on current account. So, the exporters and importers are having much better conditions, it was not available in India before 1991 because of the trade policy reforms the now India is having 100 percent full convertibility on current account. But, at the same time international monetary fund and other international agencies are also pressurizing India for a last many years that you can also have the full convertibility on the capital account.

So, the full convertibility on the capital account India is not ready to accept, because what is basically the capital account is, capital account is nothing expect the freedom to convert local financial sets into the modern once at market determined exchange rates, it lead to the free exchange of currency at lower rates and then unrestricted mobility of the capital. So, a capital invested in a country is free to move out when the investor feels to move out, there will not be any problem in the currency exchange.

So, beneficial for a country because inflow of the capital investment increases any

economy and one cannot forget to cite here the example of 19 the Asian countries before 1997 which has received a huge capital especially through the for an institutional investment and the moment they were having certain problem in the economy. Because, the East Asian countries were having short term debt from the international lending agencies. And average debt was calculated more than 80, 90 percent of the GDP in some of the country the net GDP ratio was above 90 percent.

So, when the matter came to the investor, investor thought at this point that this is not the economy to continue for the investment and they have started running out from the Asian markets. And before 1997 many economists and various studies were treating South Asia as one of the Asian tigers and soon after the crisis started, these tigers had no phase, because they were having full convertibility on the capital account.

Since, they were having the full convertibility on the capital account, a large full of investment they received, there were many hopes in the economy that through this investment they are going to get certain better result. But finally, when the investors started flowing out from the country they were not in the position to really face the new challenges and the new challenge was the complete disaster in terms of economic development.

So, the flips side of this full convertibility on capital account, it could these stabilize in economy due to the massive capital flows in and out of the country and that happened in 1997 in case of East Asian crisis. So, India has full convertibility of rupee and current account, but has limited convertibility and capital account and due to this fact many institutional investors they do not want to really look for India as the prime destination. Because, they are not really certain and they are very much sure that their entire investment, they are not getting to have full exchange at ((Refer Time: 23:37)), but they will have only resultant percentage of investment in their hand in case of any bad conditions of the economy.

So, if one can see the investors interest, investors want those economies where they have the full convertibility on their investment, full exchange of their investment. But, when a country is not having such policy to have the full convertibility of the investment, in that case investors are really worried that what will happen in case of any crisis of that economy and that way India is treated as one of the safe economy, even during the financial crisis, recent financial crisis much impact is not one India, because we were not

having full convertibility and the capital account.

But, at the same time investors are not really giving a very positive remark on the Indian economy, because India is not allowing them to have a complete convertibility on their investment. And in a absence of that investment a lot of infrastructure investment, which is not really direct investment which they are treating as the indirect investment through the institutional investments or not really reaching to the country.

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CAC and Infrastructure Development

- Foreign investors can invest in infrastructure and other sectors without any barrier
- Constraint on domestic investment in infrastructure can be relieved through CAC
- Attract foreign capital for mega power projects and highway projects
- Urban infrastructure and smart cities development can be financed through CAC

Foreign investors can invest in infrastructure and other sectors without any barrier, if a country is having capital account convertibility. Because, a partial convertibility is one of the barrier for the investor and other investor only one is looking for what they are getting from the market. Because, investors wants return and the return is not possible when there are uncertainties and when the economy has certain crisis.

So, constant and domestic investment in an infrastructure can we relieved through the capital account convertibility. So, majority of the projects which lack today in terms of getting the funds from the various companies, it is not really possible without having the full convertibility of the capital account. But, at the same time attracting foreign capital for omega power projects and highway projects are possible with certain risk on capital account convertibility, because if India allow for the full convertibility and capital account, it is a fact that India will receive a much large pool of infrastructure funds and investment from various part of the world.

But, at the same time those investments will be again one of the risk investment, because

we are not sure that how long that investment is going to continue, if there are certain risk of India is facing are any development country is facing. So, urban infrastructure in a small cities development which is the smart city development is one of the agenda of the government today. It is not possible to have the resources for this type of development as indicated by various investors investment body that India a country like India if they are not really opening up the economy further like they are arguing that not having the full convertibility on capital account is basically the drawback on the economic liberalization of India.

So, India should and India must do this full convertibility on capital account, but at the same time there is calculation as again one of the major issue after taking care of after taking lessons from East Asia and taking lessons from the recent financial crises, it is indeed important to really have a re look on the capital account convertibility. Because, this type of capital account full convertibility on capital account is really helpful when we are looking for more in more investment, but it is really a shocking when a country is facing certain imbalances maybe the economic imbalances and imbalance may be the political imbalances or the social imbalances.

So, to conclude the entire discussion if we can see here that FDI and FII has a very prominent rule in infrastructure development today. Any developing country which has high potential to grow, it cannot really work, it cannot really grow faster today without the help of the FDI and FII, a varieties of a large full of literature is available and how FDI and the economic growth is inter connected.

But, at the same time the studies on full convertibility and capital account do show that as long as a countries are not really having a better macroeconomic indicators any such full convertibility on capital account is going to lead us into a new disaster. So, taking lessons from the past and present, the fact is that foreign institutional investment or direct investment is required, but at the same time we cannot really grow up without these investments, a proper regulation of the government policy, a proper regulatory environment for receiving such infrastructure funds is indeed important today. And India must find out the new challenges in receiving those infrastructure related funds whether it is through the institutional or whether it is through the direct investment.

I think this discussion gives you an idea that how government policy on investment is influencing the receiving of certain infrastructure funds and if government policy is

really having the new way of liberalization, new economic reforms on the way then certainly we will get some more funds, because infrastructure development is impossible without receiving the international funds.

Thank you.