To cap it all

India's limits on foreign ownership are keeping out much-needed investment.

It was meant to be India's biggest-ever foreign direct investment (FDI). But Vodafone's acquisition of 67% of Hutchison Essar, India's fourth-biggest mobile operator, for $11.1 billion, has run into regulatory trouble. India's central bank suspects that the deal, announced in February, would violate a 74% limit on foreign ownership of telecoms firms. The Foreign Investment Promotion Board (FIPB) has been asked to review the purchase and has twice deferred ruling on it. It is due to reconvene on April 23rd, when it is expected to suspend judgement yet again.

Under the terms of the deal, which values Hutchison Essar at $18.8 billion, Vodafone would buy 52% of the firm outright from HTIL, a unit of Hutchison Whampoa of Hong Kong. The remaining 15% is held by two Indian individuals and an Indian private-equity firm on HTIL's behalf. Vodafone plans to buy this stake from HTIL and retain the same arrangement. Crucially, this slab of the firm, mostly held by Asim Ghosh, Hutchison Essar's managing director, and Analjit Singh, chairman of Max India, a health-care group, is not considered to be foreign-owned.
If the Vodafone deal changed this, it would put an illicit 89% of Hutchison Essar in alien hands. That is because the remaining 33% of the company held by Essar, an Indian steel and oil-refining conglomerate, includes 22% held offshore. In principle, the government is behind Vodafone; but winning approval for the deal will not be easy. For example, the FIPB has asked Vodafone why it bragged in a press release of buying 67% of Hutchison Essar if, as it now claims, it stands to own only 52%.

Before the regulatory wrangling, the deal was notable mainly for its size. But if it now goes ahead, it is more likely to be remembered for the way it bent the rules on FDI. These have been eased, or scrapped, in recent years. Manufacturing, computer services and some financial services, such as asset management and stockbroking, are among the many industries open (or mostly open) to foreigners. Overall, India is as open as any other emerging market. But those restrictions on FDI that remain are in some of its fastest-growing industries—including telecoms, banking, aviation, retailing and newspapers. The central bank plainly fears that Vodafone could set a troublesome rule-bending precedent.

That would be infuriating for a government that is caught between the necessity of upholding the law and the desire to win more FDI for the country. On April 14th the trade and commerce minister, Kamal Nath, announced that India had attracted $15 billion in FDI in the financial year that ended in March, almost a threefold increase on the previous year. This came on the back of a few liberal reforms, economic growth averaging over 8% in the past four years and a general bullishness towards emerging markets.

In spite of that increase, India remains desperate for FDI. Last year's success is still a modest figure, representing only about 1.5% of GDP, against China's decade-long average of about 3%. In this financial year, Mr Nath hopes to attract FDI of $25 billion.

India needs FDI above all to help develop manufacturing, which represents only 15% of its economy—though it is growing according to plan. FDI in manufacturing—“the sweetest of all FDI”, says Mr Nath—also grew, and amounted to $6 billion in total. But the overall increase in India's FDI was dominated by investments in property development, from almost nothing to around a third of the total, in response to hugely inflated property prices in Mumbai and Delhi. Chetan Ahya, Morgan Stanley's economist in Mumbai, says these investments could therefore be considered to be “speculative in nature”.

To secure vastly increased investment in manufacturing, India needs to do more than just fiddle with its rules limiting FDI. It also needs to improve its crumbling infrastructure, reform constrictive labour laws and remove many of the administrative hurdles it erects in companies' paths—especially in manufacturing.

Fonte: The Economist, v. 383, n. 8525, p. 76-77, 21 April 2007.