India's Investment Environment – July 2009

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I. Introduction

India faced a huge drop of 43 percent in the FDI inflow in May 2009 in comparison to the same month of the previous year. However, with improving liquidity, promising industrial output and rising confidence in the economy in recent times, FDI inflow is expected to improve. In India, the service sector attracts the largest share of foreign capital inflows followed by computer software and hardware, telecom, housing and real estate.

To attract more FDI, the government has been continuously making serious efforts to simplify the FDI policy and provide an enabling business environment in India.

II. Expected changes in FDI rules

The following changes in FDI rules are expected in the near future:
(i) Foreign investment in higher education may be allowed
India plans to open its higher education sector to foreign investment and have legislation in place to allow entry by top foreign universities such as Harvard, Stanford and Yale. This will help provide skills to millions of its young people and control their exit abroad for education. On an average, 160,000 students go abroad to study.

India is one of the most attractive education markets but historically the government has not encouraged foreign participation in this sector. It faces an enormous challenge to provide education to young people, especially in remote locations. According to the National Knowledge Commission estimates, the country needs to build 1,500 universities within a period of five years to equip enough people with the skills to sustain rapid growth.

(ii) Higher FDI in print media may be allowed
In a marked shift from its previous position, the government is planning to open up FDI in news print media further up to 49% from the current level of 26%. Earlier the government was not in favour of hiking FDI in media.

The print sector, along with other corporate sectors, has been hit by the unprecedented economic crisis which forced the government to review its policy. It is, however, learnt that the government will not allow publication businesses to be controlled entirely by foreign management. .Moreover, some large print media players are not in favour of further liberalisation of the present FDI framework.

(iii) Government is likely to hike defence FDI cap to 49%
Driven by the urgent need to establish a strong defence industrial base in the country, the government is likely to raise FDI in the defence sector from 26% to 49% later this year. The

government is fully committed to the development of a vibrant and proactive defence industry in India.

The problem with the present 26 percent ceiling on FDI is that it limits the economic incentive provided to the foreign investor. The proposal of allowing 49% will permit greater inflow of money into the sector and will ensure indigenisation of India's defence imports

India opened its defence industry to the private sector in May 2001 and allowed 100 percent private investment with FDI up to 26 percent. However, progress has been slow as Indian armed forces continued to import the major chunk of their military hardware and software from various countries.

(iv) Government eyes FDI from Germany, France to boost textile growth

The government has undertaken an ambitious project to attract FDI into the textile and apparel sector mainly from France, Germany, Switzerland and Italy as these nations have good technology at their disposal. To this end, the government has appointed a committee and entrusted it with the task of preparing a work plan for attracting foreign investments. According to industry estimates, the sector requires investment worth $8 billion by 2012 to meet expected demand.

India allows 100 percent FDI in the textile and apparel sector without prior approval. However, the sector attracts less than one percent of the total FDI coming into the economy, the reason being inadequate production facilities and higher prices leading to lower exports. The sector is highly decentralised and 96% of the production of fabric and garments is considered commercially non-viable.

(v) Government clarifies real estate investment policy

The government has made it clear that the lock-in period of three years applicable to foreign investments in the realty sector, under Press Note 2 of 2005, is applicable for the entire investment, against the previous understanding that it applied only for the initial investment.

According to the press note, the government allows FDI up to 100 percent in townships, housing, built-up infrastructure and construction and development projects. Minimum capitalisation of $10 million and $ 5million respectively is required to set up wholly owned subsidiaries and joint ventures with Indian partners. Non-repatriation of the original investment for a period of three years starting from completion of minimum capitalisation is mandatory. Previously, it was understood that 'original investment' meant 'initial investment'. The government has now clarified that it implies total investment.

III. News & Views

(i) Lock-in on foreign investment in real estate may dampen sentiments

It is being debated that the government clarification about the lock-in period for foreign investment in real estate may help some firms tide over their current cash crunch but could adversely affect long term investment sentiments. The clarification is being considered as a negative move from the perspective of foreign investors. It is also being argued that with this change in interpretation, India would be perceived as a high regulatory risk economy. This will hit small and medium realty firms as they rely more on private equity funding.

(ii) The retail sector bargaining for FDI

In order to protect indigenous small and medium retailers, the Parliamentary Standing Committee on Commerce recommends a 'blanket ban on domestic corporate heavyweights and foreign retailers from entering into retail trade in grocery, fruits, vegetables, and restriction on opening large malls by them for selling consumer products'. The Committee also recommends that 'Government should stop issuing further licenses for cash and carry, either to tarns national retailers or to a combination of trans national retailers and the Indian partner, as it is a mere camouflage of doing retail trade through the back door'.

These recommendations of the Committee are being seen as regressive. The government permitted FDI (Press Note 3 of 2006) in this sector in 2006 to attract investments into production and marketing, encourage sourcing of goods from within the country and enhance competitiveness of Indian enterprises. In the light of the recent changes it is being asked whether the Indian retail landscape has drastically changed from 2006 to now.

However, corporate India is eager to hear the government's response to their request for industry status for retail. Foreign investors are hopeful that the government will not consider the above recommendations of the Committee and will undertake economic reforms by allowing 100 percent FDI at least in single brand retail and partial FDI in multi-brand retail.

(iii) FDI in education can save country's billions of dollars

Around 160,000 Indian students are studying abroad, spending a huge amount of approximately $ 4 billion per annum on foreign universities. It is being debated that if government allows for 100 percent FDI in higher education, it will not only help in providing cheaper yet better quality education but also save India billions of dollars by way of foreign exchange outgo. The government is planning to present the Foreign Educational Institutions (Regulation of entry and Operations, Maintenance of Quality and Prevention of Commercialisation) Bill to the Parliament.

It is being argued that if the Bill is passed, it will not only bring in the much needed investment but it will also attract more foreign students to come to India for higher education.

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