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A monthly publication from South Indian Bank

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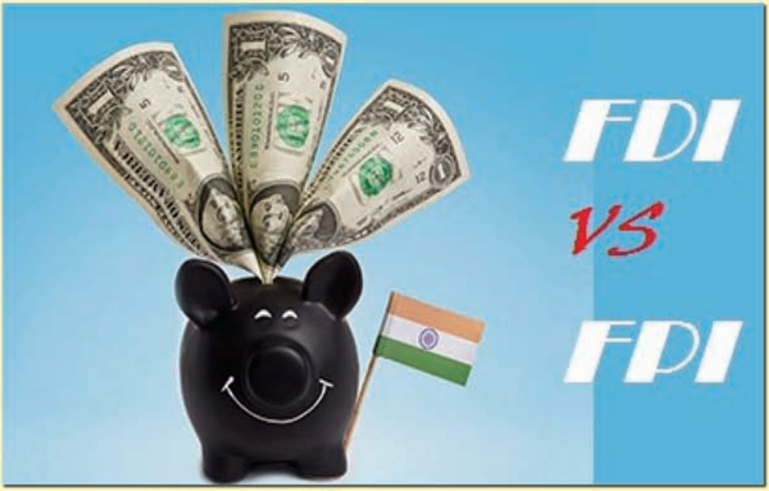
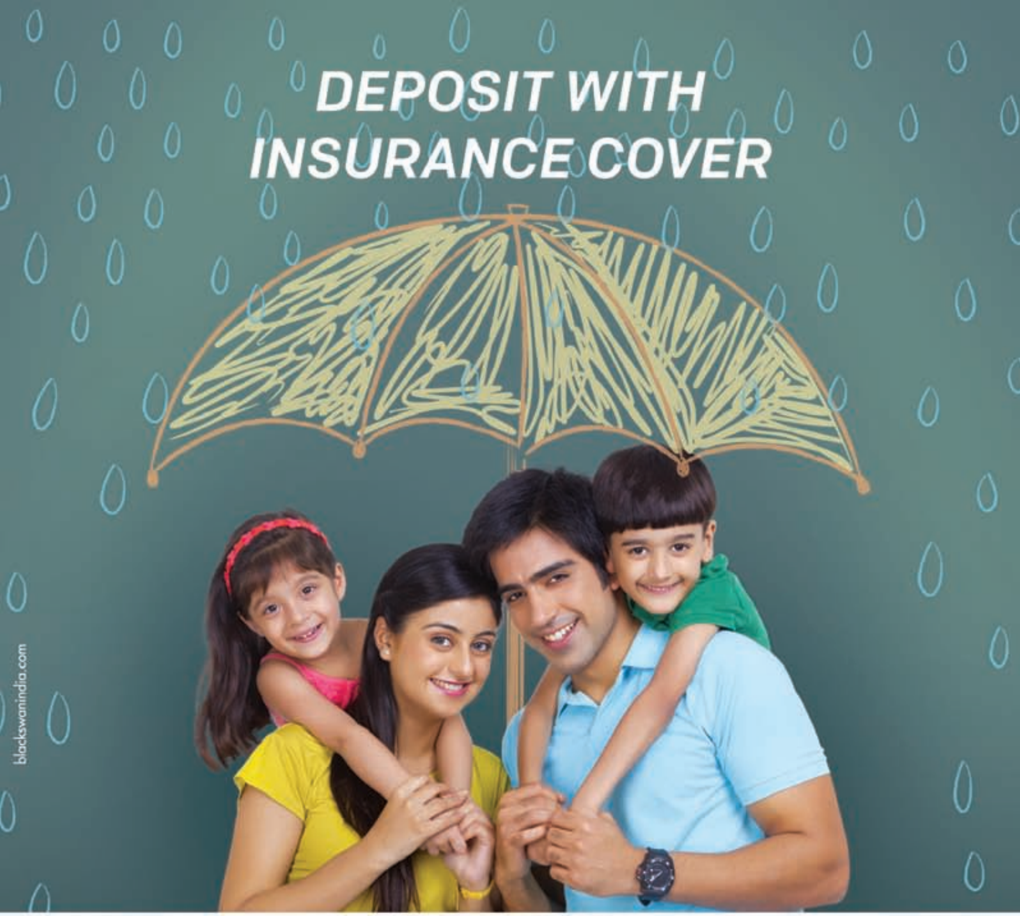


AUGUST 2019

Theme 333

"FDI vs. FPI "



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SIB STUDENTS' ECONOMIC FORUM

AUGUST, 2019

Theme No: 333: **"FDI vs. FPI"**

A well informed customer will make the policy makers as well as organizations which produce goods and render services more responsive to the customer needs. This will also result in healthy competition among organizations and improve the quality of its products. The "SIB Students' Economic forum" is designed to kindle interest in the minds of younger generation. We highlight one theme in every monthly meeting of the "Forum". Topic of discussion for this month is "**FDI vs. FPI".** Every country requires capital for its economic growth and the funds cannot be raised from its internal sources alone. Foreign Direct Investment (FDI) and Foreign Portfolio Investment (FPI) are the two ways through which foreign investors can invest in an economy.

Foreign Direct Investment

Foreign Direct Investment (FDI) implies an investment made with intent of obtaining an ownership stake in an enterprise domiciled in a country by an enterprise situated in some other country. The investment may result in the transfers of funds, resources, technical know-how, strategies, etc. There are several ways of making FDI i.e. creating a joint venture or through merger and acquisition or by establishing a subsidiary company.

The investor company has a substantial amount of influence and control over the investee company. Moreover, if the investor company obtains 10% or more ownership of equity shares, then voting rights are granted along with participation in the management.

Benefits of FDI

Foreign Direct Investment offers advantages to both the investor and the foreign host country. These incentives encourage both parties to engage in and allow FDI.

Benefits for businesses:
- Market diversification
- Tax incentives
- Lower labour costs
- Preferential tariffs
- Subsidies

Benefits for the host country:
- Economic stimulation
- Development of human capital
- Increase in employment
- Access to management expertise, skills, and technology

For businesses, most of these benefits are based on cost cutting and lowering risk. For host countries, the benefits are mainly economic.

Disadvantages of FDI

Despite many benefits, there are still two main disadvantages to FDI such as:

1. Displacement of local businesses
   The entry of large firms such as Walmart may displace local businesses. Walmart is often criticized for driving out local businesses that cannot compete with its lower prices.
2. Profit repatriation
   In the case of profit repatriation, the primary concern is that firms will not reinvest profits back into the host country. This leads to large capital outflows from the host country.

As a result, many countries have regulations limiting foreign direct investment.

Foreign Portfolio Investment

Foreign Portfolio Investment (FPI) refers to the investment made in the financial assets of an enterprise, based in one country by the foreign investors. Such an investment is made with the purpose of getting short term financial gain and not for obtaining significant control over managerial operations of the enterprise.

The investment is made in the securities of the company, i.e. stock, bonds, etc. for which the overseas investors deposit money in the host country's bank account and purchase securities. Usually, FPI investors go for securities that are highly liquid.

An individual investor interested in opportunities outside their own country is most likely to invest through an FPI. On a more macro level, foreign portfolio investment is part of a country's capital account and shown on its balance of payments (BOP). The BOP measures the amount of money flowing from one country to other countries over one monetary year.

Advantages of FPI

a) Enhanced flows of equity capital.
b) Managing uncertainty and controlling risk.
c) FPI inflows help in financial innovation and development of hedging instruments.
d) Improving capital markets.
e) Enhance competition and efficiency of financial markets.
f) Equity market development aids economic development.
g) Improved Corporate Governance.

Disadvantages of FPI

a) Induces Inflation.
b) Political risk represented by the possibility of change in the political environment resulting in change in investment norms and repatriation regulations.
c) Emerging markets which are the beneficiaries of most FPI traditionally suffer from low retail participation which results in inadequate liquidity which will in turn lead to price volatility.

d) Due to the unpredictable nature of such funds there is a tendency to shift from one market to another at short intervals. Volatility arising out of FPI inflows and outflows has adverse effects on the host country's economy.
e) Emerging economies tend to have depreciation prone currencies. This exposes the foreign investor to exchange rate risk on both principal and returns.

Foreign Direct Investment VS Foreign Portfolio Investment

BASIS FOR COMPARISON	FDI	FPI
Aim is	To increase enterprise productivity or capacity	To increase capital availability
Flows into	Primary Market	Secondary Market
Role of investors	Active	Passive
Degree of control	High (As the investors gain both ownership and management right through investment, the level of control is relatively high)	Very less (Degree of control is less as the investors obtain only ownership right.)
Term	Investors have a substantial and long-term interest in the firm	Short term
Suitable for	Province of institutional investors, Ultra high net worth individuals and companies	Average retail investor
Management of Projects	Efficient	Comparatively less efficient.
Investment in	Physical assets (financial and non- financial assets like resources, technical know-how along with securities)	Financial assets only
Eligible for	Profits of the company	Capital Gain
Tends to be	Non Speculative	Speculative
Liquidity	Less Liquidity	More Liquid
Risk	More Risk	Less Risky
Entry and exit	Difficult (It is not easy for FDI investors to sell out the stake acquired)	Relatively easy(Investment is made in financial assets which are liquid, they can be easily sold)
Results in	Transfer of funds, technology and other resources. Access to markets and management inputs.	Only capital inflows
Impact on employment of labour and wages	Direct impact	No direct impact

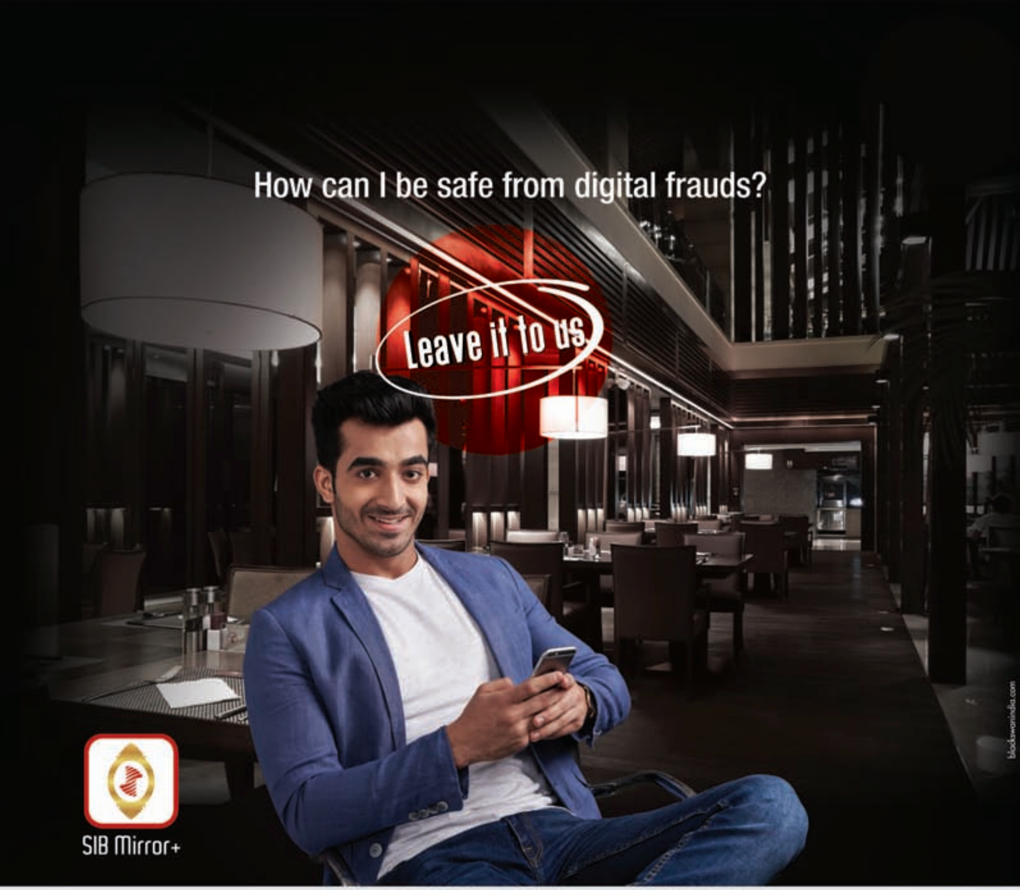
While FDI and FPI can be sources of much-needed capital for an economy, FPI is much more volatile, and this volatility can aggravate economic problems during uncertain times. Since this volatility can have a significant adverse impact on their investment portfolios, retail investors should familiarize themselves with the differences between these two key sources of foreign investment.

FDI & FPI in News

- The Union cabinet cleared a number of changes in Foreign Direct Investment (FDI) regulations, including easing rules for overseas single-brand stores and permitting FDI through the automatic route in contract manufacturing and all areas of coal mining.
  - The changes in the FDI policy aimed at making India a more attractive destination for foreign investments, boosting employment and economic growth.

	Measure	Expected Impact
1.	Single brand retail sourcing norms eased	More Foreign brands may set up physical stores in India and establish their presence
2.	100% FDI allowed in contract manufacturing	Electronic, pharma firms are likely to set up manufacturing facilities in India
3.	100% FDI in coal mining through automatic route	Move will help create an energy efficient market
4.	26% FDI limit extended to digital media	This brings digital news services on a par with print and allows them to be valued separately.

- Telecommunications, services and computer software were the top areas attracting Foreign Direct Investment (FDI) in India during the first quarter of the on-going fiscal. The total inflows into all sectors increased by 28 per cent to $ 16.33 billion
- According to India Ratings, China would continue to crowd out capital flows to emerging markets like India and consequently, FPI inflows would remain under pressure. Foreign funds flow into India is expected to face headwind over the near-to-medium term despite the accommodative global monetary policy stance and rolling back of tax surcharge on FPIs by the government
- The government rolled back the enhanced surcharge imposed on foreign portfolio and domestic investors in Budget 2019-20 as it announced a slew of measures to boost sagging economic growth.
- Finance Minister announced various capital market initiatives including a higher public holding in all listed companies and merger of the investment routes for foreign portfolio investors (FPIs) and non-resident Indians (NRIs).
- India received the highest-ever FDI inflow of $64.37 billion during the fiscal ended March 2019.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