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Subir Gokarn: Intermediation in infrastructure

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The National Investment Fund offers a way to sustain resource flows into infrastructure.

For the past few years, many people including myself have felt that finance was not the binding constraint on infrastructure development. With the right policies and regulatory framework in place, it would be possible to create viable business models, which, given the increasing appetite of investors around the world for the India story, would then have no problems raising resources.

This viewpoint was validated by the occasional success, when policy reforms made it possible for the private sector to get projects off the ground. Therefore, the delays and dithering in pushing ahead with reforms in several sectors, or failing to implement measures that had already been legislated, were predominantly to blame for the widening gap between demand and supply. This, in turn, threatened the sustainability of growth.

Over the past few weeks, the situation appears to have completely reversed. As slow and painful as it may seem, the UPA government did get the ball rolling on infrastructure reforms. Despite the controversies surrounding them, airports, mega-power projects and urban transport systems have found willing private investors, who in turn have built significant amounts of foreign investment into their very large funding requirements. Across the board, policy frameworks are changing to accommodate private motivations while protecting the public interest.

But, just when things appeared to be falling into place, global financial conditions have turned rather hostile. In the light of recent developments, it is hard to imagine that even very attractive projects will be able to raise funds with great difficulty, if at all.

In these circumstances, we could think of a return to the predominantly government-financed infrastructure model that we have spent the past decade trying to break away from. Given its record of project implementation, service quality and maintenance standards, this would certainly send a shudder down many a spine. But, sustaining growth demands that these investments be made and public investment, even with its drawbacks, is better than no investment at all.

Unfortunately, even this option is severely constrained by the state of public finances. In the past few months, they have been burdened with subsidies, waivers and salary hikes. Further, state governments, which have been spared the consequences of the first two, are all set to feel the pressure of the third from next year onwards. All this means that the room for expanding public investment is rather limited in the short term. Meanwhile, the gap just keeps getting wider.

At this point, it is difficult to say how long the constraints on foreign investment flows will persist. Even as the US and Europe anticipate a decline in growth in 2009, the outlook for most of Asia, including China and India, remains relatively positive. The monetary cycle in the region, as in the rest of the world, has turned decisively towards a growth stimulus, supplemented by fiscal packages in countries which have the capacity. This, in and of itself, should create conditions for capital flows into these countries to reverse direction.

However, the ability and willingness of global investors to respond to those conditions remain in doubt. Macroeconomic sluggishness combined with financial fragility will make investors extremely cautious of venturing out of the comfort zone of, for example, government securities and into anything remotely risky. Emerging markets may remain attractive long-term prospects, but for the next year and perhaps longer, the focus will be on the immediate future.

To the extent that foreign investors are willing to venture back into emerging markets, including India, it will be into relatively safe channels. In the equity market, large firms with stable markets and dependable managements will dominate the list. New projects being put together in still uncertain policy environments will be at the very bottom of the list. If foreign investment is to be channelised into infrastructure, rather than wait for things to take their own course, the government must think of playing an intermediary role.

Fortunately, although the fiscal situation has deteriorated during the year, the government has the capacity to turn things around very quickly. Disinvestment has almost completely disappeared from the policy lexicon. Early in its term, in an attempt to make disinvestment politically acceptable, the UPA government set up the National Investment Fund. This was supposed to use funds raised through disinvestment in projects that would be approved by the members of the coalition. The idea never took hold, partly because the political management proved to be difficult, but also because rapid growth and fiscal improvements lifted the pressure on government to find alternative resources.

Conditions are very different now. The National Investment Fund provides a mechanism for the government to play the role of intermediary between foreign investment and infrastructure. As foreign investors re-consider their Indian portfolios, a significant increase in the availability of equity in public enterprises will be alluring. The ones that are already listed are mostly companies that meet the size and stability criteria that investors will be looking for. Government holdings in these can be significantly diluted. There are others, which also meet the criteria and will become attractive with credible governance and management processes being put into place.

However, for this strategy to work, business-as-usual with respect to investment decisions and governance will simply not do. The government's role as a financier of infrastructure may be significant in the current economic situation, but its limitations in project management, service delivery and maintenance cannot be overlooked. Also, given that the investments made by the Fund will have very long horizons and will therefore require credible commitments, the political dimension is also very important.

Rather than putting decisions off for the next government, the UPA would be well advised to begin talking to other parties about setting up a durable framework for the National Investment Fund. It can take on the primary responsibility for providing infrastructure finance to independently managed and commercially viable projects, which might have, under different circumstances, had no difficulty in raising funds.

When markets return to normal, which they must at some point, it can continue to play a backstop role, making sure that the flow of funds remains as full and as timely as requirements dictate. A governance structure that accommodates multi-partisanship should keep it relatively immune to changes in the ruling coalition.

The world over, the role of government in economic performance is being re-considered. We need to do the same, but not lose sight of the bitter lessons from our past experience.

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