Globalisation and Private Infrastructure Investments in Emerging Markets

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ABSTRACT

The budgets of many emerging economies are overstretched by competing claims on the available resources, with major implications for infrastructure and service delivery. This is a serious predicament particularly in poorer emerging economies where inadequate infrastructure imposes huge constraints on sustainable development. To augment the public sources of funding for infrastructure investment, several of these countries are developing various schemes that will enable the utilization of private financing from both domestic and international investors. Domestic sources of financing may be limited in these countries, and globalisation appears to offer a window of opportunity for tapping private capital for infrastructure investment.

Despite the above benefit, it is argued that globalisation has brought a mixed basket of hope and disillusionment to emerging markets. On the one hand, there is the euphoria that comes with increased private capital inflows and market access, and on the other, there is disenchantment with the negative consequences of certain forms of foreign investment. The financial crises that occurred in Asia and Latin America are cases in point. These apparent contradictions have severely heightened the fears of globalisation harboured by emerging markets. Nevertheless, it is argued that globalisation can have a positive impact and that the onus lies on emerging economies to develop and adopt the strategic measures necessary to manage the process of globalisation to their advantage, subsequently to benefit from increased capital flows into infrastructure investments.

Keywords: emerging markets, FDI, globalisation, private infrastructure investments.

BACKGROUND

There is a critical need for an alternative model for infrastructure financing in emerging economies. This need is predicated upon the urgent desire for effective and efficient infrastructure and service delivery sufficient to make material differences to the lives of many impoverished citizens. Given the low domestic capital base of many emerging economies, caused by a very low savings rate, foreign direct investments are increasingly seen as a possible bridge. This is particularly the case given that the rapidly unfolding process of globalisation seems to have reduced the world to a global village, minimising the incidence of externalities and market failures. Access to information and goods and services has increased. The resultant global competition has positive impacts on economies of scale, to the benefit of consumers through lower overall costs. Whilst unfair trade practices and catastrophic financial crises have been closely associated with the globalisation process, there is the belief that the process can be effectively managed towards desirable objectives.

For the emerging economies, globalisation has presented daunting challenges. The volume and volatility of capital flows has increased the risks of banking and currency crises, as well as costs (World Bank 1999 in Yusuf, 2001). Examples of currency crises were seen in Latin America and Asia. Production and trade is increasingly dominated by transnational corporations using the options afforded by globalisation to their own best advantage (Yusuf, 2001). The subject of globalisation has attracted numerous emotional responses, and eminent scholars such Joseph Stiglitz, the winner of the 2001 Nobel Prize in Economics, have raised some serious concerns.

The main source of discontent can be found in the pressures mounted on the developing countries by the developed countries to dispense with trade barriers and other restrictive trade practices under the guise of globalisation and free trade, while imposing formidable trade barriers on exports from developing countries. Stiglitz (2003) discusses the latter issue in some detail. Developing countries have been denied access to markets through sophisticated tariff structures and administrative measures. The results are increasing dependence on multilateral financial assistance. The exorbitant proportion of gross domestic product devoted to debt servicing has heightened the suspicion of developing countries and fuelled resistance to globalisation. Nevertheless, it has become apparent that the process of globalisation is unstoppable, which means that developing countries have to adopt policies that will enable them to benefit from it while minimising the drawbacks.

INTRODUCTION

The construction industry plays a significant role in any economy, but it is dependent on other sectors of the economy which are susceptible to the globalisation process. As a result, the construction industry is affected by globalisation in varying ways that may not have been fully explored. In a review of globalisation and construction industry development, Raftery *et al* (1998) argue that some of the possible negative implications of globalisation are that:

- There is a danger that local industries which support the construction sector could be stifled, crippling the competitiveness of the domestic construction industry.
- The internationalization of construction favours countries with advanced construction industries. This is manifested in the trend that pure contracting is usually no longer a viable option in construction projects; new construction procurement arrangements are preferred. The involvement of lesser developed countries in foreign construction projects is thus constrained, except perhaps in the area of labour deployment, and even then, this is usually at the much lower end of the value added construction process where relatively little in the way of skills is expected.
- As the international construction industry is concerned mostly with large-scale construction, only large and technologically qualified contractors are allowed to enter into overseas contracts. The prequalification requirement in bidding procedures of

foreign construction projects precludes the participation of medium-sized operations or those in pure contracting. To be able to qualify, a firm must demonstrate that it has previously secured a certain amount of contracts of comparable magnitude and complexity.

Ofori (2000) further elaborated on the analysis of Raftery *et al* (1998). Through citing various authors, he drew attention to the impacts of the globalisation process, including the loss of business opportunities for local firms (Ofori, 1996) and the loss of confidence in local firms (Hillebrandt, 1999). This could probably be attributed to the lack of competitive strength of local firms relative to the elaborate technological and managerial capacity of global firms. Nevertheless, some positive impacts of globalisation have been cited by Ofori (2000), including the impact on national development objectives through the completion of sophisticated projects which are impossible with local contractors (Drewer, 1980) and business opportunities for local contractors through subcontracting and strategic alliances (Ofori, 1996). These opportunities could be beneficial to local contractors given an appropriate production function.

This paper does not attempt to exhaust the complex debate around the pros and cons of globalisation; instead it focuses on the responses that developing countries must adopt to minimise the negative impacts of the globalisation process. The objectives of this paper are thus to:

- Highlight the drivers of global capital flows into infrastructure investment.
- Analyze the amounts of global capital flows invested in private infrastructure in different regions of the world.
- Assess the impact of private capital flows on infrastructure in emerging markets in terms of the contribution to overall investment in the economy and the likely attendant impact on socio-economic and development indicators.
- Recommend a strategic position to be adopted by emerging economies to facilitate the increased flow of funds into infrastructure investments and simultaneously seek to minimise the risks of adverse effects from foreign capital.

The possibility of fulfilling these objectives has been gauged by undertaking an analytical review of the amounts and impacts of global capital flows into infrastructure investments in emerging economies. The major contribution of this paper to the globalisation debate has been the departure from the macro approach in favour of an industry approach. The rationale being that such a micro understanding of the globalisation process lays a better foundation for the much wider aggregate or macro analysis and strategies.

DRIVERS OF GLOBAL CAPITAL FLOWS INTO INFRASTRUCTURE INVESTMENT

At this juncture it is perhaps useful to distinguish foreign direct investment (FDI) from other capital flows. Several authors have identified capital flows with the biological phenomenon – 'good and bad cholesterol' (Hausmann and Fernández-Arias, 2000, Loungani and Razin, 2001). This approach distinguishes between capital flows that enable development and capital flows that disrupt economic growth and development. It is argued that FDI is 'good cholesterol' when it has some associated favourable elements, for example, technology transfer and skills development. The 'bad cholesterol' is speculative capital flows, represented by debt, especially of the short-term variety (Hausmann and Fernández-Arias, 2000).

It is argued that the flow of FDI as 'good cholesterol' is driven by numerous factors. Furthermore, it has also been argued that the drivers of investment in particular sectors of the economy are diversification benefits, risk and return, the regulatory framework, and industry analysis (Chege, 2003). Ramamurti and Doh (2004) classify the drivers as industry level and country level, and argue that infrastructure FDI boomed in the 1990s due to several beliefs explained as follows.

- Industry level drivers. Ramamurti and Doh (2004) argue that there was the belief that:
    - infrastructure sectors were losing their "natural monopoly" characteristics and hence the need for government regulation;
    - first-movers would profit handsomely from the resulting globalisation of infrastructure sectors;
    - new financing techniques would limit the Multinational Corporation's (MNC's) risks;
- Country level drivers. For these drivers, Ramamurti and Doh (2004) argue that there was the belief that:
    - the climate for infrastructure FDI in developing countries had changed qualitatively for better in the 1990s; and, finally
    - host developing countries were no longer likely to expropriate foreign infrastructure assets, as they had in the past.

In addition to the above, this paper identifies three other FDI drivers, namely the investment objectives of investors, performance of the stock market, and the nature of corporate governance.

The investment objectives of the investor are significant to the investment decision-making process. Strong (2003) discusses four main investment objectives, namely stability of principal, income, capital appreciation and growth of income. These objectives have a direct relationship with the degree of risk that the investor is willing to undertake. For example, Zoukis (2004) highlights that the Germans purchased close to $4 billion in US real estate in 2003. An historical aversion to the US stock market, coupled with a conservative investment style and patient-money mentality, make their continuing investment in this sector a safe bet.

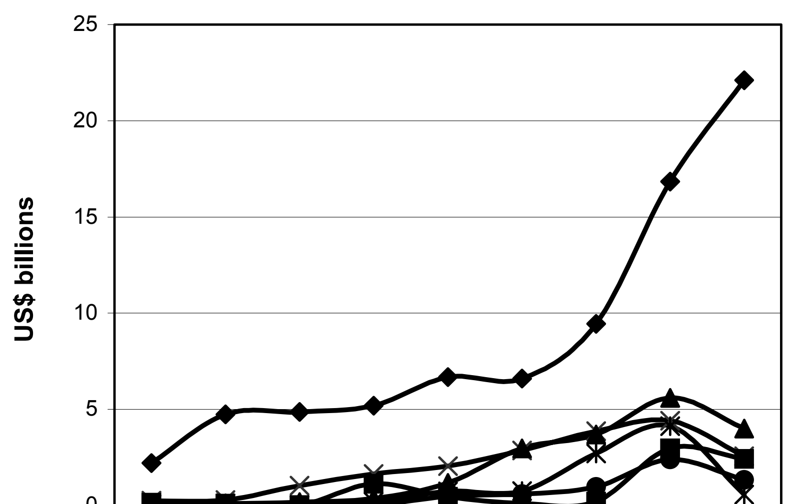
In recent times, the declining trend in stock market returns has also been an important driver of capital into alternative investments such as infrastructure and real estate; it can be argued that globally, real estate has also become a safer investment when compared to equities. Ernst and Young (2004) have stated that *"large global funds have shown significant interest in investing in real estate assets on a globally diversified basis. Three years of tremendous losses in the equity markets have further intensified the interest in global real estate investment opportunities."*

With the recent financial scandals in major corporations, investors are also becoming increasingly concerned about good corporate governance. The Organization for Economic Cooperation and Development (2004) holds a similar view and states that the relationship between corporate governance and the increasingly international character of investment are of particular importance. Furthermore, international flows of capital enable companies to access financing from a much larger pool of investors.

AMOUNTS OF GLOBAL CAPITAL FLOWS INVESTED IN PRIVATE INFRASTRUCTURE IN DIFFERENT REGIONS OF THE WORLD

Since the 1990s, the capital flows into infrastructure have increased dramatically in most regions, for various reasons. According to Ramamurti and Doh (2004), FDI flows to the infrastructure sectors of developing countries in the early 1990s represented one-third of all capital flows. Sader (2000) states that between 1990 and 1998, developing countries received an estimated US$138.3 billion in FDI inflows directly through private infrastructure investments, representing over 17% of total FDI commitments in the developing world.

Figure 1 presents a regional pattern of FDI flows to infrastructure, from which it is clear that Latin America and the Caribbean had the greatest share of infrastructure FDI flows between 1990 and 1998.



	1990	1991	1992	1993	1994	1995	1996	1997	1998
East Asia and Pacific	0.24	0.29	1.03	1.64	2.04	2.86	3.87	4.40	2.57
Europe and Central Asia	0.03	0.10	0.17	0.35	1.17	2.98	3.68	5.59	4.00
Latin America and the Caribbean	2.21	4.74	4.87	5.19	6.67	6.60	9.44	16.84	22.12
Middle East and North Africa	0.14	0.09	0.01	1.13	0.45	0.11	0.20	2.96	2.43
South Asia	0.07	0.11	0.01	0.19	0.74	0.75	2.71	4.13	0.57
Sub-Saharan Africa	0.01	0.00	0.02	0.02	0.49	0.60	0.97	2.40	1.33

Figure 1: FDI Capital Flows to Infrastructure by Region
(Not e: 1998 data are estimates)

Source of data: Sader (2000)

In 1995, FDI slowed down a little in the region but there was a significant increase in 1996. The Asian financial crisis caused a dramatic decrease in investment in East Asia and the Pacific after 1997. After 1997, the financial crisis also had a large role to play in the dramatic decrease in investment in all the regions except Latin America and the Caribbean. After the crisis, the surviving resources for private infrastructure were mainly dedicated to projects with political risk insurance or guarantees from multilateral development banks (Izaguirre and Rao, 2000).

By 2001, private investment in infrastructure in developing countries had declined by more than 50% from its 1997 peak, whereas FDI in non-infrastructure sectors continued to grow through 2000 and declined slightly only in 2001 (Ramamurti and Doh, 2004).

Impact of private capital flows into infrastructure in emerging markets

In assessing the impact of the increased private capital flows depicted in Figure 1, this paper argues that private capital flows have had a major impact in terms of fiscal expansion, the extension of services and efficiency. This paper also highlights that distinguishing between the impacts of private domestic capital and private foreign capital is complex because of the difficulties in obtaining disaggregated data.

FDI flows have led to fiscal expansion. It is highly likely that privatisation in many countries has bolstered government revenue in three respects. Firstly, money previously devoted to the kind of infrastructure now provided by the private sector could be diverted to other competing areas of the economy. Secondly, governments' revenues should have also risen through tax charges on the infrastructure services provided by the private sector. Thirdly, through various procurement systems associated with FDI flows, such as build-operate-transfer (BOT), where the private sector is not only responsible for financing the infrastructure but also for operations and management, there should be improvements to cost recovery for services rendered. One of the major constraints on infrastructure provision and replication is the low scope for cost recovery owing to increased resistance to service payments. This is because of the perception that public services should be free of charge even to those who can afford to pay. Therefore, the significance of cost recovery to infrastructure provision in many emerging economies should not be under-estimated.

It is also argued that there has been extension of services across the procurement value chain due to FDI flows into infrastructure. The use of FDI in BOT-type of contracts has ensured that there is sufficient investment to cover the provision of services throughout the service delivery lifecycle. Due to the long-term nature of these contracts, there is a guarantee that service levels will be maintained at optimum levels specified and infrastructure assets will not be subject to dilapidation due to lack of maintenance; as often is the case particularly when budgets are constrained. In addition, the use of BOT type contracts has also resulted in efficiency gains. There is a growing body of evidence on the impact of private participation, revolving around the issues of increased efficiencies as a result of private sector participation. Some examples of increased efficiencies are provided by Harris (2003), who states that Borlotti *et al* (2001) found that 31 privatized telecommunications companies in 25 developed and developing countries saw significant improvements in operating efficiency. Harris (2003) also states that Estache and Kouassi (2002) found that water companies in Africa were more efficient than public ones.

Evidently, FDI flows hold a promising opportunity for increased infrastructure investments in developing countries, but individual countries have to devise a strategy for attracting FDI flows because of the intense competition for available resources.

STRATEGIC POSITION AND CONCLUSION

In adopting a strategy to cope with the above challenges, one of the major stumbling blocks for the construction industry is that the global markets for infrastructure and real estate are not homogenous. This implies that some markets are more robust than others and as a consequence remain the dominant direction of FDI flows. Nevertheless, in response to the challenges to FDI flows presented in this paper, some strategic decisions that might be taken by developing countries to attract FDI into infrastructure investment are as follows.

First, an effective industrial strategy is essential. This would minimize reliance on foreign inputs and expertise and ensure that FDI facilitates the transfer of skills and knowledge to the developing countries. Second, the adoption of appropriate corporate governance standards, transparency, accountability and the prevention of opportunistic behaviour are critical. Third, the creation of an enabling environment with an institutional framework to facilitate private infrastructure is essential. Conducive legal and property rights frameworks are necessary to enforce guarantees and obligations. Previously, there have been cases of compulsory acquisition or nationalisation of the assets of foreign companies by developing countries. This has served to discourage foreign direct investment and unless efforts are made in terms of progressive policies, the hardened attitudes of FDI investors are unlikely to shift. There must also be adequate infrastructure in place to support the process of globalisation. This would include adequate transport and communications networks to facilitate the processes.

This paper highlights that FDI capital flows into infrastructure have increased since the 1990s. The paper argues that these capital flows have been driven by various factors namely, industry and country level factors, the investment objectives of the investor, the trends in the stock market and corporate governance requirements. The analysis in this paper suggests that FDI could provide opportunities for financing infrastructure investments in the developing countries to augment dwindling government revenues. The paper highlights that FDI could continue to have several positive impacts through fiscal expansion, extension of services and efficiency. The managerial and technological skills transfer that accompanies FDI could ensure efficiency and effectiveness of infrastructure production and delivery. However, the paper strongly argues that FDI does not flow in an institutional vacuum; it requires effective domestic economic strategies in order to provide the intended benefits.

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