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FDI in South Asia

Scope for cooperation

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Till fairly recently, received wisdom had it that investment followed trade. But globalization and the frenetic need for companies to constantly lower costs in a fiercely competitive world have increasingly led corporates to invest overseas to take advantage of cheap raw materials and/or cheaper skills even where trade links are, at best, tenuous.

Trade has then followed such investment. For instance, it is estimated that a significant part of Chinese exports are from multinational corporations that have established their base in China. With sovereigns now joining the game to garner cheaper natural resources, especially in Africa—China being a prime example again—it is clear the old order has changed. Investment will increasingly lead, not follow, trade.

Despite growing evidence of the symbiotic links between investment and trade, the members of the South Asian Association for Regional Cooperation (SAARC) as a whole have been slow to exploit the potential of such links within the region.

TRADE INTEGRATION

South Asia is the least-integrated region in the world. If on the political plane, there is considerable distrust between neighbouring countries, especially India and Pakistan, in the economic arena, all countries in South Asia adopted highly interventionist trade regimes in the early years of their growth.

This began to change in the late 1970s when Sri Lanka became the first to liberalize, followed by others in the 1980s. SAARC was established in 1985 as a first step towards closer regional integration. The process of economic integration finally culminated in a traditional regional trade agreement aimed at reducing trade barriers—the Agreement on South Asian Free Trade Area (SAFTA).

In addition to SAFTA, there are four free trade agreements (FTAs) among South Asian countries: India-Bhutan, India-Nepal, India-Sri Lanka, and Pakistan-Sri Lanka; and two sub-regional preferential arrangements: the Asia-Pacific Trade Agreement and the Bay of Bengal Initiative for Multi-Sectoral, Technical and Economic Cooperation (BIMSTEC). Four FTAs are under negotiation: India-Pakistan, India-Bangladesh, Sri Lanka-Maldives and Pakistan-Bangladesh.

All these are traditional FTAs aimed at reducing or eliminating barriers only in trade in goods, excluding services, competition, intellectual property rights, government procurement and investment. In this respect, South Asia is a bit of an outlier in a world where most FTAs, in recent years, have moved beyond reducing barriers in goods trade to involve specific commitments on investment.

INVESTMENT INTEGRATION

If the situation of intra-regional trade flows in South Asia is disappointing, the picture of intra-regional investment flows is far worse. The participation of South Asian countries in other forms of foreign direct investment (FDI) undertakings such as Bilateral Investment Treaties (BITs) and Double Tax Avoidance Treaties (DTTs) is negligible. Although South Asian countries are involved in 109 BITs overall, there are only four BITs in the region. Similarly, DTTs are in force primarily among India, Pakistan, Bangladesh and Nepal. Bhutan and the Maldives are not members of any such treaties.

In a bid to promote and protect investments in the region, a Draft Regional Agreement on Promotion and Protection of Investment within SAARC has been under consideration since September 1997. However, progress has been excruciatingly slow.

FDI IN SOUTH ASIA

In line with the much higher level of global investment flows in recent years (except last year when they fell dramatically following the global financial crisis), FDI to South Asia has also been increasing over the years. According to the United Nations Conference on Trade and Development (UNCTAD), from an average of US$2.5 billion per year during 1990–2000, FDI to the region increased to an incredible US$51 billion in 2008 (Table 1). Surprisingly, despite the global meltdown, all countries (with the exception of Bhutan, Nepal and Pakistan, the latter two possibly because of political instability during the year) received more FDI in 2008 than in the previous year.

Within these overall trends, individual countries performed highly unevenly (Table 2). The driving force behind the receipt of most FDI from developed-country sources is related to the industrial sophistication of the host country, availability of cheap skills, the size of the home market and of course, infrastructure. It is no surprise, therefore, that India, which is the most advanced country in the region industrially, should attract most of the FDI inflows from the developed world to the region. An UNCTAD survey ranks India among the five-most attractive places for FDI globally.

The sources of FDI are highly diversified in most SAARC countries. Though the dominant tendency is still for the FDI to originate in developed countries, the share of developing countries is also fairly significant (Table 3). During 2006–2007, Organisation for Economic Co-operation and Development (OECD) countries contributed only 27 percent of the total FDI to India. However, this ignores the fact that the FDI which is routed through Mauritius and Singapore for tax reasons and accounts for 49 percent of FDI inflows to India also originates primarily in developed countries.

In Sri Lanka, a middle-income country, the major investors are from the United States (US), the United Kingdom (UK) and Australia. The share of the non-OECD investment in Pakistan, during 2006–2008 was 60.5 percent, and it was 51.2 percent in Bangladesh during 2005–2006. In Nepal, until 2005/06, of the 50 countries that had their commercial presence in the country, 33 were developing countries, accounting for 66 percent of the FDI in the country. Very few FDI projects have been commissioned in Bhutan.

DETERMINANTS OF FDI

Locational proximity is seen to be an important determinant of investment decisions for developing-country firms, including those in South Asia. Fifty-six percent of the non-OECD investment in Pakistan during the past two years originated from neighbouring West Asia. In Bangladesh, closely

Table 1 Overall FDI trends in South Asia (US$ billion)

	1980–1985	1990–2000	2003	2004	2005	2006	2007	2008
South Asia	0.2	2.5	5.7	7.6	9.9	22.3	34	50.7
Asia	5	76.6	110.5	170	208.7	259.4	331.4	387.8
Developing countries	12.6	134.7	175.1	283	314.3	379.1	26.8	36.6
World	49.8	495.4	557.9	742.1	945.8	1,305.9	1,978.8	1,697.4

Source: UNCTAD's World Investment Report 2009, www.unctad.org

Table 2 Inward FDI flows

	US$ million					as % of gross fixed capital formation			
	1999–2000	2005	2006	2007	2008	1999–2000	2006	2007	2008
India	1,705	7,606	20,336	25,127	41,554	1.9	6.9	6.5	9.6
Pakistan	463	2,201	4,273	5,590	5,438	5.1	16.1	18.3	18.3
Sri Lanka	159	272	480	603	752	5	6.8	7.5	7.3
Bangladesh	218	845	793	666	1,086	2.9	5.3	4	5.9
Maldives	9	9	14	15	15	7	2.8	2.9	2.5
Nepal	6	2	-7	6	1	0.9	-0.3	0.2	n.a.
Bhutan	n.a.	9	6	73	30	0.4	1.2	10.9	3.9

Source: UNCTAD's World Investment Report 2009, www.unctad.org

situated South and Southeast Asian countries were the major developing-country investors accounting for more than 24 percent of the total FDI in the past two years. In recent years, Egypt and the United Arab Emirates have also emerged as major investors in the country. In Nepal, India and China accounted for about 60 percent of the country's total FDI during 2005–2007. Similarly, Sri Lanka has a large commercial presence of firms from close-at-hand Singapore, Malaysia, South Korea, Hong Kong and India.

Apart from locational proximity and, to some extent, cultural and religious links (Saudi Arabia, for instance, is a fairly big investor in Pakistan), ease of doing business, quality of infrastructure, size of the market and its sophistication, as well as the availability of skilled human resource also appear to be powerful determinants of FDI inflows to South Asia.

HAVE FTAS MADE A DIFFERENCE?

If only geographical proximity is considered an important determinant of FDI flows into developing countries, one should expect large intra-regional FDI flows in South Asia. Although intra-regional FDI flows in South Asia have increased in the post-2000 period, with a few exceptions, they remain rather small. Regional FDI flows into the three largest recipients of FDI, namely India, Bangladesh and Pakistan, are negligible. However, Nepal, and since 2002, Sri Lanka, have been attracting substantial FDI from India (Table 4).

The Sri Lankan experience is one of the best examples of the intra-regional investment potential in South Asia. Historically, India has not been a major investor in Sri Lanka. In 2000, India's share was just about 2 percent of Sri Lanka's total FDI stock and it did not even figure among the top 10 investors in Sri Lanka. But in the next five years, it ranked the fourth largest. Such a dramatic increase in FDI flows from India into Sri Lanka was due to the coming into effect of the India-Sri Lanka FTA.

Sri Lanka also has an FTA with Pakistan that came into operation on 12 June 2005. This has the potential to not just promote trade between the two countries, but also between India and Pakistan. Currently, Indo-Pak trade takes place mostly via Singapore or Dubai. By encouraging Pakistani investors to set up operations in Sri Lanka in order to trade with India

Table 3 Sources of FDI

Host country	Year	Top 5 countries	Share of top 5 countries (%)	Share of traditional OECD countries (%)	No. of identified source countries
India	2006 & 2007	Mauritius, UK, Singapore, US, NRI	66.1	27	100
Bangladesh	2005 & 2006	US, UK, Egypt, UAE, Norway	68	51.2	31
Pakistan	2006–2007 & 2007–2008	US, UK, UAE, Netherlands, Switzerland	64.1	60.5	33
Nepal	2005–2008	India, China, South Korea, Japan, Canada	67	22	25
Sri Lanka	2002	Malaysia, Singapore, UK, India, USA	62	n.a.	n.a.

Sources: Board of Investment for Pakistan and Bangladesh; Department of Industry for Nepal; Secretariat for Industrial Assistance for India; UNESCAP for Sri Lanka.

Table 4 Intra-regional FDI flows (% of country total)

	India		Bangladesh		Pakistan		Nepal		Sri Lanka
	2001–2003	2006–2007	1995–1996	2005–2006	2001–2005	2006–2008	Upto 2006	2006–2007	2005
India	-	-	0.620	0.540	0.001	0.002	40.710	46.600	6.200
Bangladesh	-	-	-	-	0.050	0.100	0.750	-	0.180
Pakistan	-	-	1.400	1.870	-	-	0.470	-	0.600
Nepal	-	-	-	-	-	-	-	-	-
Sri Lanka	0.009	0.014	0.230	0.410	-	-	0.130	-	-
Bhutan	-	-	0.005	-	-	-	0.010	-	-
Maldives	0.008	0.009	0.000	-	-	-	0.000	-	n.a.
Share of South Asia	0.017	0.023	2.250	2.820	0.060	0.102	41.800	46.600	7.000

Sources: Board of Investment for Pakistan and Bangladesh; Department of Industry for Nepal; Secretariat for Industrial Assistance for India; UNESCAP for Bhutan.

using the Indo-Sri Lanka FTA, the island nation can gradually acquire an entrepot status in South Asia. This can further promote FDI inflows to Sri Lanka.

Pakistan has opened all its sectors for FDI. However, investment inflows from within the region are still negligible, although Bangladesh's investment in Pakistan has increased in the past two years. So far, Bangladesh and Pakistan do not have an FTA with each other but are working towards putting one in place. The countries, however, have formed a Joint Economic Commission, a Joint Working Group and a Joint Business Council, as well as a Joint Investment Company to finance joint ventures in several key areas.

In the case of Bangladesh, during the period 1995–2006, regional FDI accounted for an average of 2.25 percent of the total FDI flows into the country. But, in the past two years, it increased to 2.82 percent, primarily owing to increased FDI from Pakistan. Investment from Sri Lanka has also increased to some extent. In Nepal, until the end of 2006, there were a total of 1,067 foreign projects. Of them, more than one third were from the region itself, with India accounting for the lion's share.

CONCLUSION

Though new investment opportunities are emerging in South Asia and intra-regional FDI flows are increasing, the pace of growth is very slow, especially when compared to the potential that exists. Neither multilateral liberalization nor regional integration has succeeded in making a significant impact on intra-regional FDI flows.

While shallow regional integration remains a key deterrent to increased intra-regional investment flows, part of the reason is that SAFTA, limited as it is, does not include investment within its scope.

South Asia could learn from the experiences of other regional blocs such as the Association of Southeast Asian Nations and the European Union, and instead of confining itself to agreements on goods trade, expand their scope to cover investments as well. ■

SAWTEE
SOUTH ASIA WATCH ON TRADE, ECONOMICS & ENVIRONMENT

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ABOUT US

South Asia Watch on Trade, Economics & Environment (SAWTEE) is a regional network that operates through its secretariat in Kathmandu and 11 member institutions from five South Asian countries, namely Bangladesh, India, Nepal, Pakistan and Sri Lanka. The overall objective of SAWTEE is to build the capacity of concerned stakeholders in South Asia in the context of liberalization and globalization.

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