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FDI IN SOUTH ASIA: CHALLENGES AND PROSPECTS

Introduction

The term foreign direct investment (FDI) has been defined by different institutions/ scholars in different manner. However, for the purpose of this briefing paper, we borrow the definition of the World Trade Organisation (WTO) which, in our opinion, best summarises the meaning of FDI as: "FDI occurs when an investor based in one country (the home country) acquires an asset in another country (the host country) with the intent to manage that asset. The management dimension is what distinguishes FDI from portfolio investment in foreign stocks, bonds and other financial instruments."[1]

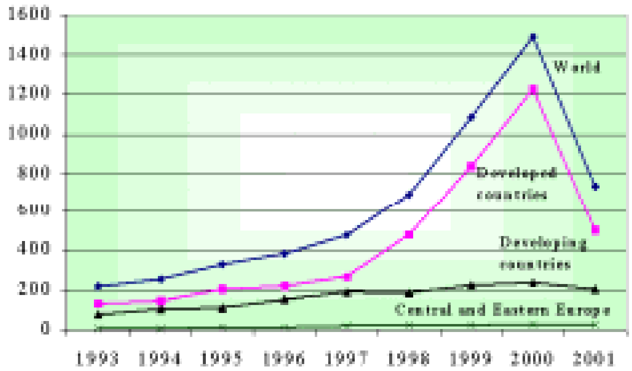
FDI has been one of the hotly debated and sensitive issues in international economics. There is no dearth of people who could emphatically argue either in favour of or against FDI. There are many factors, both economic and non-economic, that need to be analysed extensively so as to have a comprehensive understanding of the issue at hand. The objective of this briefing paper is to highlight major issues related to FDI with reference to South Asian countries and other developing countries as appropriate and make some policy recommendations on the way forward.

FDI trend

Until the mid-eighties, FDI had a bumpy ride. Many countries were very suspicious of the effects of FDI in their economies and tried hard to check its flow by taking measures like restrictions on capital and profit repatriations, performance requirements etc. But, this situation no longer exists. Countries have now changed their policy frameworks in order to attract as much FDI as possible and develop a meaningful partnership with foreign firms.

This accommodating strategy has produced some results — FDI has generally been increasing. According to Human Development Report in South Asia 2001, FDI in the world was US$ 68 billion in 1960, US$ 502 billion in 1980, US$ 1948 billion in 1992 and US$ 3,456 billion in 1997. The share of FDI in developing countries has also been rising: from 22 percent in 1992 to 30 percent in 1997. However, its share decreased to 19 percent in 2000, the lowest since 1991 in spite of the fact that the amount for developing countries increased by eight percent to US$ 240 billion that year. It is now projected to be around 30 percent, the same level attained in 1997. The caveat in this largely encouraging trend for developing countries is that FDI has been concentrated in few countries that are rich in natural resources and have higher per capita income.

Amount in billions



Source: www.unctad.org

Sectoral distribution of FDI inflow has also been changed. In 1970s, half of the total inflow of FDI was in manufacturing sector and a quarter each in primary and tertiary sectors. Now, the proportion of FDI on tertiary sector has increased. The share on primary sector has declined and that on manufacturing sector has reduced slightly, but it still occupies the major share of FDI.

In recent years, FDI has been increasing, in absolute terms, in South Asia. FDI inflow in the region was approximately US$ 458 million in 1990, US$ 2,000 million in 1995, US$ 3,426 million in 1998 and US$ 4,200 million in 2001. FDI inflow in the region is almost proportionate to the gross domestic products (GDPs) of these countries. Increasingly, India is receiving the lion's share of this amount. The reasons for this will be dealt with later in the paper.

It should, however, be kept in mind that FDI inflow in South Asia is relatively small, even in relation to developing countries. FDI is just 0.5 percent of the GDP in the region.[2] While South Asia's share in the GDP of developing countries is nine percent , it represents only about two percent in the case of FDI.

Why FDI?

Overseas Development Assistance (ODA) or foreign aid is generally the most preferred mode of receiving foreign money by the developing nations. But, because foreign aid has been dwindling in recent years, there is a fierce competition among countries to attract it. The other information that is relevant here is that even in the heyday of foreign assistance, it never reached 0.7 percent of the developed countries' national income, the level most developed countries had committed to spend on assisting developing countries. This figure has consistently been hovering at around 0.3 percent. Since it has been obvious that ODA alone will not be sufficient to meet the developing countries need, they have been looking for alternative sources for funds.

Private loans might not be very forthcoming in developing countries. The international private lending agencies might feel that providing funds to countries they do not know very well is rather risky. Furthermore, the institutions in borrowing countries are also wary of private loans especially after the onset of the debt crisis in the early eighties. Compared to government loans, private loans tend to be more short-term and might have serious repercussions, the Mexican Crisis being one example.

Portfolio investment, by its very nature, is risky and volatile. Very large inflow or outflow could create a destabilising effect on the host countries' economy. The East Asian crisis in the second half of 1990s is a painful reminder of how large outflow of financial assets could threaten the financial stability of the whole region.

Since FDI is not as fungible as portfolio investment, it is said that developing countries are more enthusiastic about FDI. With foreign firms incurring high sunk costs, they are less likely to leave the host country immediately. There must also be a relatively long- term commitment and perspective on the part of foreign firms bringing in FDI. Those countries actively pursuing FDI also believe that there are other rewards associated with FDI.

However, it might be necessary to underscore the fact at the onset that there are some economists who argue that the very assumption FDI is less volatile is misplaced. They reason that if the situation in the host country deteriorates, the foreign firm will be able to transfer most of its resources to the home country leaving only "bricks and mortars" in the host country without incurring much cost. Moreover, they can also transfer the cost of "bricks and mortars" to the domestic partners. There are others who believe that the host country will lose the most precisely because FDI is not the best alternative for the multinational corporations (MNCs) and MNCs are aware of this. In an ideal scenario, MNCs would prefer portfolio investment because they could easily withdraw their money and avert huge financial loss when the economic environment deteriorates in the host country. This might not be the case with FDI. With FDI, foreign corporations need to be adequately compensated for this risk undertaken. So, they only invest in areas that are comparatively less risky or in those sectors where the expected return is relatively very high.

There are still others who argue that countries' greater reliance on FDI demonstrates the financial vulnerability of those countries. They reason that if the condition of the country were strong, they would not hesitate to raise the money by focusing on, say, portfolio investment. But, supporters of this school of thought have declined after the Asian Financial crisis for obvious reasons.

WTO and investment

The issue of making rules to liberalise foreign investment has surfaced time and again. It was vigorously pursued by the North in the Uruguay Round. The developing countries protested against any formal agreement citing they were not fully prepared and needed more time to study its consequences. In the end, however, they were forced to agree on four agreements that have implications on investments: Trade-Related Investment Measures (TRIMS), General Agreement on Trade in Services (GATS), Trade-Related Intellectual Property Rights (TRIPS) and the Agreement on Subsidies and Countervailing Measures (ASCM). Those agreements were also short of what the developed countries had hoped to accomplish. The 1996 WTO Singapore Ministerial then had decided to form a working group to examine the relationship between trade and investment, and to study and identify the genuine concerns raised by member states that "may merit further consideration in the WTO framework"[3]. The Declaration of the Fourth Ministerial Conference in Doha (November 2001) has provided a mandate for, *inter alia*, the working group to discuss on the modalities of negotiations for an investment agreement. But, there remain many obstacles in the way of signing an agreement. Everyone is aware of the fact that agreements on investment are highly contentious. The very fact that Organisation for Economic Cooperation and Development (OECD) countries, who have similar policies in many fronts, failed to reach an accord on Multilateral Agreement on Investment (MAI) illuminates the difficulties faced in such negotiations. Developing countries, including those in South Asia, have rightly realised that these agreements should not be done in a rush as they tend to be binding. In-depth study needs to be undertaken before committing to such treaties.

Further, there is a difference in opinion among developed and developing countries on new agreements. Developed countries are very much interested in a comprehensive agreement on investment to safeguard their business interests in foreign countries. But, developing countries are more concerned about the implementation aspects of previous treaties than to committing to new ones. They feel that they have been cheated in previous negotiations—they had made many sacrifices in the hope that the developed nations would keep up with their promises and also reciprocate, but many thorny issues, for example, agricultural subsidies, access to medicine, and textile quotas etc. still remain unsolved. They further reason that they have already signed many bilateral and multilateral agreements that address the concerns of the parties interested in investing in developing countries. In fact, United Nations Conference on Trade and Development (UNCTAD) reports that over 1,600 Bilateral Investment Treaties (BITs) had been negotiated by 2000, as against 400 at the beginning of 1990.[4]

Sources of FDI

The main sources of FDI are MNCs. Their share of FDI has been increasing—it is about 95 percent now. They invest in other countries to capture the internalisation, localisation and ownership advantages. The transaction cost is greatly reduced if they themselves own subsidiaries abroad. It is also easier to penetrate in foreign market with subsidiaries abroad. With ownership, they can also freely transfer their technology and intellectual property without much fear of their misappropriation.In addition, the reductions in transport and communication costs have made foreign investments more lucrative. They are now able to base different levels of production in different countries to capture the benefits that a particular place can provide. In short, they estimate that the benefits outweigh the costs associated with the investment in a foreign country.

Most MNCs are based in developed/industrial nations and their investments are also mostly directed towards other developed nations. But, they are now expanding their outreach to developing countries as well. The US, Japan and the United Kingdom are the three major countries that have been investing in developing countries.

Benefits cited for FDI

Transfer of technology: This is one of the key reasons mentioned by those advocating FDI. It is believed that with the increase in FDI, there will be a transfer of technology. Since foreign firms maintain control over the firms, it is argued that they do not mind exporting their state-of-the art technology. Empirical studies have shown that the vertical linkage has been one of the most effective ways to transfer technologies. But, when there exist huge differences between the technologies used in the host and home countries, it might not produce desired results. This is understandable because the host country might not have the necessary skilled human resource. There are still others who go on to say that the MNCs might start using inferior technologies in the host country and thus inhibit technological progress there.

Transfer of capital: Developing countries have realised that FDI might be the solution for their inadequate access to foreign capital. It could be the driving force for economic growth and development. Developing countries have painfully learnt, over the years, that domestic savings alone might not be enough to solve their outstanding developmental needs. The problems associated with raising capital from alternative sources have been addressed above.

Enhancement of managerial capacity and skills: Since profit maximisation is the goal of MNCs, they will manage the firm efficiently. They will hire the best management staffs and provide adequate trainings to hone their skills. All this happens in pursuit of self-interest!

Access to world market: It is generally agreed that MNCs are better positioned to penetrate foreign markets. They have subsidiaries in many countries. In addition, they also have the resources and expertise to study foreign markets and come up with excellent strategies to enter those markets.

Employment generation: This is one of the most debated issues. Empirical studies are not definitive about the effect on net employment. MNCs will undoubtedly hire local people. But, their activities might force some domestic firms, especially those producing similar products or services, to shut down. The net effect on employment is therefore inconclusive at best. To have a definitive answer, we must look on how labour-intensive the domestic firms and MNCs in the particular country are.

FDI vs. international trade

There are some serious differences among economists regarding whether FDI substitutes or complements international trade. Since FDI mainly caters to domestic markets, some argue that this will contribute towards reducing international trade. Others who oppose this view say that MNCs, which provide the bulk of FDI, are heavily involved in international trade. About one third of the trade occurs as a result of intra-corporate trade between units of MNCs and another one third involves a unit of MNC and some other institution[5]. The generally agreed view is that if MNCs are involved in the same stage of production in different countries, this might reduce international trade. Otherwise, they should increase trade between countries.

Policies towards attracting FDI

Developing countries are now competing with one another to attract FDI. So, they are adopting different measures in order to portray their serious commitments to lure FDI. Before, as mentioned earlier, many countries adopted restrictions like performance requirements, local ownership requirements and limitations on profit repatriation in order to reap as much of the expected return as possible. Countries adopting these strategies believed that these restrictions would not put off potential MNCs from investing in their countries. Countries, aware of the fact that if there were many restrictions then the foreign firms would prefer other countries that have fewer conditionality attached, are now rushing to provide more concessions to attract FDI. They are worried that their countries will be sidelined if they do not provide sufficient incentives.

Many developing countries are now actively participating in the International Investment Agreements (IIAs) and BITs. They have realised that uncertainties greatly hamper the investment environment in their respective countries and adversely affect FDI inflow.

FDI's future in developing countries

Institute of International Finance (IIF), as cited in Newsweek, estimates that the FDI inflow in the developing countries will rise in 2003, reversing the trend observed in the last three years. But the catch here is that international investors will discriminate between "well-run and poorly run" countries. Well-run countries will be amply rewarded whereas the poorly run countries will receive little, if any, of the increase. Countries increasing their flow will include China, Mexico, South Korea, Chile, Poland, Slovakia and Czech Republic. This trend will have huge repercussions for the poor countries that are trying hard, but have been unsuccessful, to address the economic woes engulfing their countries.

Another issue that also needs to be addressed is the ramification of the economic downturn and the perceived threat of terrorism. Due to the recession in the US, Europe and Japan, FDI flow has been decreasing since 2000. Though it is projected to increase this year, this optimism should be taken with a pinch of salt as these economies are yet to rebound. Mergers and acquisitions, which are the major components of FDI, have understandably been lower as a result of the present uncertainties in the economic environment. Moreover, the threat of terrorism might force MNCs to look "in-bound" rather than "out-bound".

What do skeptics say?

Those who are critical of FDI cite several reasons to justify their claim. Major ones are given below.

Balance of payment effect: Though FDI initially has a positive effect on the balance of payments (BoP) accounts, there will be a deterioration in the capital account once the profits and dividends start to be repatriated. This concern should also be taken into account because it might negatively affect the macro economic situation of the country. Interest rates may rise as a result of the BoP deficit. The exchange rate might not be stable and this may lead to a decline in business confidence.

Destabilising effect: As has also been mentioned earlier, some argue portfolio and FDI are not very different. If the foreign firms leave the host country abruptly, then it might be very difficult for the host country to cope with the emerging situation. The economy might turn into shambles in no time.

Monopoly: Since the foreign firms have the necessary infrastructure (e.g. capital, human resource), there are many who worry that the domestic firms might not be able to favourably compete with them. MNCs might easily force domestic firms to shut down and turn themselves into monopolies and start abusing their power if the government fails to check with adequate legal provisions beforehand. With monopoly power, there might also be inefficient allocation of resources.

Environmental effect: Some foreign firms might be interested in setting up subsidiaries in other countries precisely because the environmental laws in the host country are lax. Some even argue that host governments deliberately lower their environmental standards in order to attract FDI (so called race to the bottom theory). In such a situation, they might use the resources without compensating for the damages they cause. The result is the deterioration in the environment of the host country. But this, in no way, is to suggest that domestic firms are more socially responsible with their activities.

Political effect: Sovereignty of countries, especially small developing ones could be undermined by the presence of FDI. MNCs might force developing countries to compromise on many fronts. Once FDI is allowed to enter, the opportunity cost of the foreign firms leaving the country might be very large and the host country might not be able to afford that. So the host country might accede to many demands of the MNCs, even those that might undermine the sovereignty of the nations.

Crowding out effect: Some argue that foreign investment will displace domestic investment in the host country. The net effect of investment might not be positive. They particularly relate to the case in the 1990s when large inflow of capital did not lead to increase in total investment in many developing countries and the domestic savings also decreased. "If foreign savings merely crowd out domestic savings with no change in the investment rate, the usefulness of foreign capital for capital formation, a key factor in development, can be questioned."[7]

However, Agrawal (2003), in his paper based on time-series data for five South Asian countries: India, Pakistan, Bangladesh, Sri Lanka and Nepal, argues that there exists complementary and linkage effects between foreign and national investment. According to him, empirical studies show that with one unit increase in FDI, there is more than proportionate increase in the national investment.

Effect of commercialisation: Some worry about the effect of swift commercialisation on e.g. native culture. This is one of the main reasons pointed out by those in the anti-globalisation camp. They argue that rich countries are "imposing" their culture in developing countries, with FDI only hastening the process.

China's success story: Its repercussions and lessons

China has been very successful in attracting huge inflow of FDI—it receives more FDI than India. This definitely has affected India (and South Asia) not least because both the countries have comparative advantages in similar areas, namely cheap labour and large markets, amongst others.

China's Export Processing Zones (EPZs) receive substantial FDI. The Chinese government has given large concessions there and the rules there are also very flexible. It has also concentrated on developing necessary infrastructure. The South Asian countries could learn from the Chinese experience.

It is said that non-resident Chinese have been major players in funneling FDI into China. It looks like India has finally learnt the lesson and is trying hard to woo Non-resident Indians (NRIs). Other South Asian countries especially Bangladesh and Pakistan, which have a large non-resident population, should also follow suit. One could argue that their investment will be more stable, *ceteris paribus*.

Significance of FDI in South Asia

Though the advantages of FDI mentioned in a separate heading below are equally valid for South Asia, it might be necessary to have a closer look at FDI from the development dimension as well. South Asia, one of the poorest regions of the world, had adopted different strategies to alleviate poverty, but without much success. More than 35 percent of the population still live in absolute poverty, that is, on less than a-dollar-a-day. Looking at the success stories of some East Asian countries, it can be argued that FDI could positively contribute in reducing poverty. For example, if South Asia is able to attract FDI in sectors that are labour-intensive in nature, it would greatly contribute towards employment generation and hence raise the living standards of the people in the region.

Prospects in South Asian countries

There are many reasons as to why South Asia could and should be an attractive location for FDI. The most important factor is its huge market potential. India alone has more than 1.2 billion population. China's proximity to the region is also an added advantage since the demand for many goods, for example automobiles and other white goods, is increasing there. The industries could, therefore, be setup to cater to the demands in China, in addition to those in the region. Besides, the availability of cheap labour, abundant natural resources and skilled computer literate human resource offer further opportunities.

Some areas holding immense potential in the region include investments in power sector (hydro power), exploration and exploitation of oil and gas resources, export processing zones (EPZs), software development and service sector.

Prospect for intra-regional FDI flow

India is a dominant player in the South Asian region. Since other countries, for example, Bangladesh and Nepal import heavily from India, both the countries might benefit if India directly invests in these countries. For example, the health sector in Bangladesh holds special promise. Currently, it is estimated that US$ 800 million flows to India on medical expenses from Bangladesh.[8] The outflow of funds from Bangladesh could be reduced if India invests in setting up high standard medical facilities in Bangladesh.

Considering other prosperous regional blocs, the prospect for intra-regional flow is rather slim at this point. There are many bureaucratic hurdles to go through if someone wants to invest in other countries. They should relax many of their restrictions so that the

Box 1

FDI grows satisfactorily in Nepal

The number of approved foreign investment projects in Nepal during the first half of 2002/03 slipped to 29 ventures against 46 such projects approved during the like period last year. However, FDI in monetary terms increased by about 15 percent to Rs. 1,142.16 million. The FDI projects approved during the year is expected to generate employment for additional 1,688 people.

Concerned government officials attributed increased investment in service sector to the overall growth of the foreign investment. Hospital and medical services, hydropower and construction sectors were the largest receivers of the foreign investment. The following table shows the general outlook of FDI in different sectors.

Foreign Investment in	First half of 2002-03 Rs. in million	First half of 2001-02 Rs. in million
Service sector	524.66	116.63
Construction sector	129.29	24.0
Energy based industry	372	5
Manufacturing sector	70.40	786.76
Tourism sectors	46.01	61.28

Ever since Nepal adopted liberal economic policies, companies from 44 countries have invested in 797 projects. These investments have contributed to generate over 90,546 employment opportunities. This year, the United States (US), which has invested in a single project worth Rs. 500 million, has been the largest investor. Germany with Rs. 315 million and South Korea with Rs. 114.33 million have become the second and the third largest foreign investors. The regular topper among the foreign investors, India has meanwhile slipped to the fourth position with the investment of Rs. 103.42 million.

Source: The Kathmandu Post, 16 January 2003.

investors will be free to invest in other countries if they feel that the opportunities in the "host" countries are greater.

In particular, the region might need to look up to investors from outside the region for some time to come, in addition to the "regular" ones. Other Asian countries (South East and East Asian) have started showing interest in the region. South Asian countries should also look into ways to encourage Chinese investors to invest in their respective countries.

How are South Asian countries faring?

All the South Asian countries are trying hard to attract FDI. They have all revamped their FDI policy frameworks in order to attract FDI. In absolute terms, India has been the most successful— it has been able to attract the largest share of FDI that flows into South Asia.

With the undertaking of economic reform in 1991, India has simplified many foreign investment provisions including "automatic approval of investment, liberalisation of inward investment flows, a small negative list of industries and full repatriability"[6]. These measures have had positive effects. The latest strategy has been to woo the NRIs to invest in India.

As for Nepal, the results have been rather mixed. The privatisation drive in the country has generated interests among many foreign firms. Though FDI has generally increased, FDI flow in the manufacturing sector declined drastically in the first half of 2000/03, by 91 percent. This, experts argue, was, to a large extent, the consequence of the harsher policies adopted by India over Nepal's manufacturing sector. In addition to this, India's new flexible policy towards FDI has also had the effect in reducing FDI inflow to Nepal. After all, almost anyone who invests in Nepal will obviously have an eye on India's vast market.

Despite providing huge incentives, FDI is still low in Bangladesh. Many believe that Bangladesh provides the best package of incentives in the region for the foreign investors. But, investors have largely ignored the incentive structure. Some opine that the poor performance is the reflection of its weak investment environment — poor governance, law and order situation, inefficient bureaucracy, *hartals*, etc. all have affected the inflow. They also suffer from negative imaging problem. Bangladesh is thought to be a country with acute poverty and a flood prone area. In addition, some opine that the delay in gas exports has had its toll on FDI. However, some rays of hope are emerging. In 2002, FDI quadrupled in Bangladesh. It seems like Bangladesh has finally been able to convince others about emerging lucrative opportunities which exist there.

Though Pakistan has a relatively liberal attitude towards foreign investment, FDI is generally not very forthcoming. Political instability and hence policy inconsistencies, bureaucratic hurdles and weak infrastructure are some reasons for the decline in Pakistan's share of FDI in the region. But things have improved somewhat recently. However, its continuity is not yet assured. The inflow of FDI in Pakistan is largely in financial services, energy and oil sectors.

Sri Lanka has been focusing on technology transfer and is encouraging FDI in large infrastructure projects and areas which require sophisticated technologies. The recent cease-fire is raising hopes of more FDI inflow.

Box
2

FDI quadruples in Bangladesh in 2002

Cash-strapped Bangladesh received US$ 360 million FDI in 2002, more than four times the amount received a year earlier. The state-run Board of Investment said 44 percent of the total was invested in the agricultural sector. Norway was the biggest investor in Bangladesh, contributing 19 percent of the total, followed by the US, Singapore, Hong Kong and Malaysia. The Norwegian investment mainly came in the telecom sector, while US investment was concentrated in power generation, oil, gas and medical services.

Source: The Kathmandu Post, 24 February 2003.

Box
3

FDI flows into India despite tensions

The military stand off between the South Asian neighbours, India and Pakistan, has damped the spirit of foreign investors, though Indian business groups say the impact has been exaggerated due to alarmist bulletins from foreign missions. The government of several countries (for example American, British and Japanese) warned their citizens against visiting India. This, however, did not deter investors from these countries, who had planned their investment before May, from equivocally stating their commitment to India.

Foreign bankers and business groups argue that shocks could have been offset by two factors. One, the process of privatisation and asset sales has won credibility among foreign investors, who were otherwise skeptical. Two, India's software services industry foresees a big pickup in sub-contracting back-office functions, known as business process out-sourcing. The effect of these two trends against a backdrop of diminishing geo-political tensions is likely to favour sustained FDI flows.

"Foreign investors realise that in a democracy untoward incidents do occur, yet in the long run, they feel that India is a very safe investment destination," Confederation of Indian Industries (CII) officials have commented in this regard.

Source: CUTS Newsletter, No. 4, August 2002.

Challenges ahead for South Asia

Firms would definitely be interested in the region if it provides a stable investment environment. For this, there are many areas that need to be looked into if South Asia wants a further surge in FDI.

The most important factor that needs to be addressed is the institutional development. Institutions must be strengthened so as to ensure transparency, accountability and predictability. The rule of law should be enforced. There must be fewer bureaucratic hurdles. Other incentives like tax holidays, full profit repatriation and other financial incentives might not mean much if the institutional set up is not up to the expectation of the investors. As mentioned earlier, the foreign firms look at the long-term scenario. So, if the future is rather bleak or if there are reasons to be wary, they will think twice before investing in the country.

Regional cooperation in economic front is also a must. South Asia Preferential Trade Agreement (SAPTA) and South Asia Free Trade Agreement (SAFTA) are the steps in the right direction. But, commitments should be matched by concrete actions. If the concept of regional market is realised, foreign investors will be drawn by its huge market potentials. Problem of limited market faced by many countries in the region will also be solved. Furthermore, this will provide a clear signal to potential investors that South Asia is serious about attracting foreign investment to reduce its economic problems.

Another challenge, that is equally relevant to other developing countries as well, is the unhealthy competition of providing too many incentives. Worried that other countries would outdo them, they are often seen rushing to provide more concessions. According to *Foreign Direct Investment, Development and the New Global Economic Order*, a book published by South Centre on FDI, incentives are a minor factor in deciding where to invest. “The locational advantages such as market size and growth, production costs, skill levels, political and economic stability and the regulatory framework” are relatively more important. It also goes on to suggest that developing countries are collectively losing by focusing excessively on incentive packages. These countries would have gained more had they cooperated in limiting the incentives and instead focused on improving the general business environment. This problem is felt in Sri Lanka too, where tax holidays of up to 20 years are provided in selected areas. However, investors would prefer to have better infrastructure and prompt support services (for example, communication facilities) rather than be given tax holidays. In Sri Lanka, one has to be put on a waiting list to obtain a telephone from the Sri Lanka Telecom, and it can take a minimum of several months to get one. Similar problem exists in Nepal also. This kind of delay is unheard of in developed countries, and is a major turn-off where investors are concerned.

Box
4

FDI rises in Pakistan

Foreign investment in Pakistan in the first half of the current financial year beat the total for the entire 2001-2002 financial year by 22 percent.

The FDI result for the six months to January this year was also 163.7 percent higher than the year-ago figure at about US$ 593.5 million. This compared with US$ 225.1 million for the same period a year earlier.

Financial services attracted 35 percent of investor dollars, with the oil and gas sector being the second most attractive pulling in 19.1 percent of total investment.

The United Arab Emirates accounted for almost 30 percent of Pakistan’s FDI to January, followed by Britain with almost 20 percent. Saudi Arabia and Japan were the third and the fourth highest investors.

Analysts attributed the healthy influx of overseas dollars to sales of state assets and growing investor confidence.

“The inflows of FDI mainly reflect the proceeds of privatisation of banking and oil and gas entities, as well as foreign investors’ confidence in the improvement of Pakistan’s economy,” accrding to Asif Ali Qureshi, head of research at Exilir Securities.

Source: The Himalayan Times, 20 February 2003.

Conclusion

There is no doubt that globalisation has resulted in large increase in FDI. Greater inflow of FDI has, in turn, bolstered deeper integration of world economies. Though there are some serious potential drawbacks of FDI, developing countries are not in a position to turn back from FDI. This is a reality. But, what they can and should do is to try to minimise its negative effects. They should look at ways to make FDI more meaningful. One option might be to encourage investment in certain sectors only.

In any future agreements related to investment, special consideration should be given to the interests of the developing nations. The trend of not being able to fully reap the fruits of FDI by developing nations, especially the least developed ones among them, should be reversed. It is high time that developing countries at least agree on some basic policy frameworks so that there is not much unfair competition among themselves. If the present trend of giving concessions continues without first trying to set the “basics” right, it’s obvious that developing countries will collectively lose in the long run.

South Asia now needs to concentrate on improving its investment environment. It should develop a detailed and comprehensive common investment policy. Other regions have already realised the importance of regional cooperation and have taken steps in this direction. As a result, they have now started receiving the rewards. South Asia should learn from this. Otherwise, it will lag further behind and the potential for huge FDI inflow in South Asia will not be harnessed. The challenges ahead need to be addressed sincerely and promptly.

Recommendations

- South Asia needs to work in a coordinated manner and devise a common investment policy if it is to succeed in attracting huge FDI inflow. This policy framework is long overdue.
- The governments of the region should focus on institutional development so as to ensure transparency, accountability and predictability.
- Concentrating excessively on "carrots" might not benefit the developing countries in the long run. They might be collectively losing by competing on providing more incentives.
- The possible negative consequences of FDI should also be taken into account while devising relevant policies. It is widely felt that countries tend to be "over-excited" and hence ignore this aspect while formulating policies.
- As initiated in the recent Non-aligned Movement (NAM) Meeting in Kuala Lumpur, avenues to explore ways to see how investors from the South can invest in other countries should be created.

Endnotes

[1] WTO's 1996 report as cited in Foreign Direct Investment, Development and the New Global Order.
[2] The World Bank, 13 March 2002.
[3] Foreign Direct Investment, Development and the New Global Order, page 11.
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This Briefing Paper has been prepared by Mr. Uttam Sharma of and for SAWTEE in his personal capacity. The views expressed in this paper do not necessarily reflect those of SAWTEE. For further information, please contact: SAWTEE, 254, P. O. Box: 19366, Lamtangeen Marg, Baluwatar, Kathmandu, Nepal. Ph: 977-1-4415824, 4444438. Fax: 977-1-4430608. E-mail: sawtee@sawtee.org . Web: www.sawtee.org