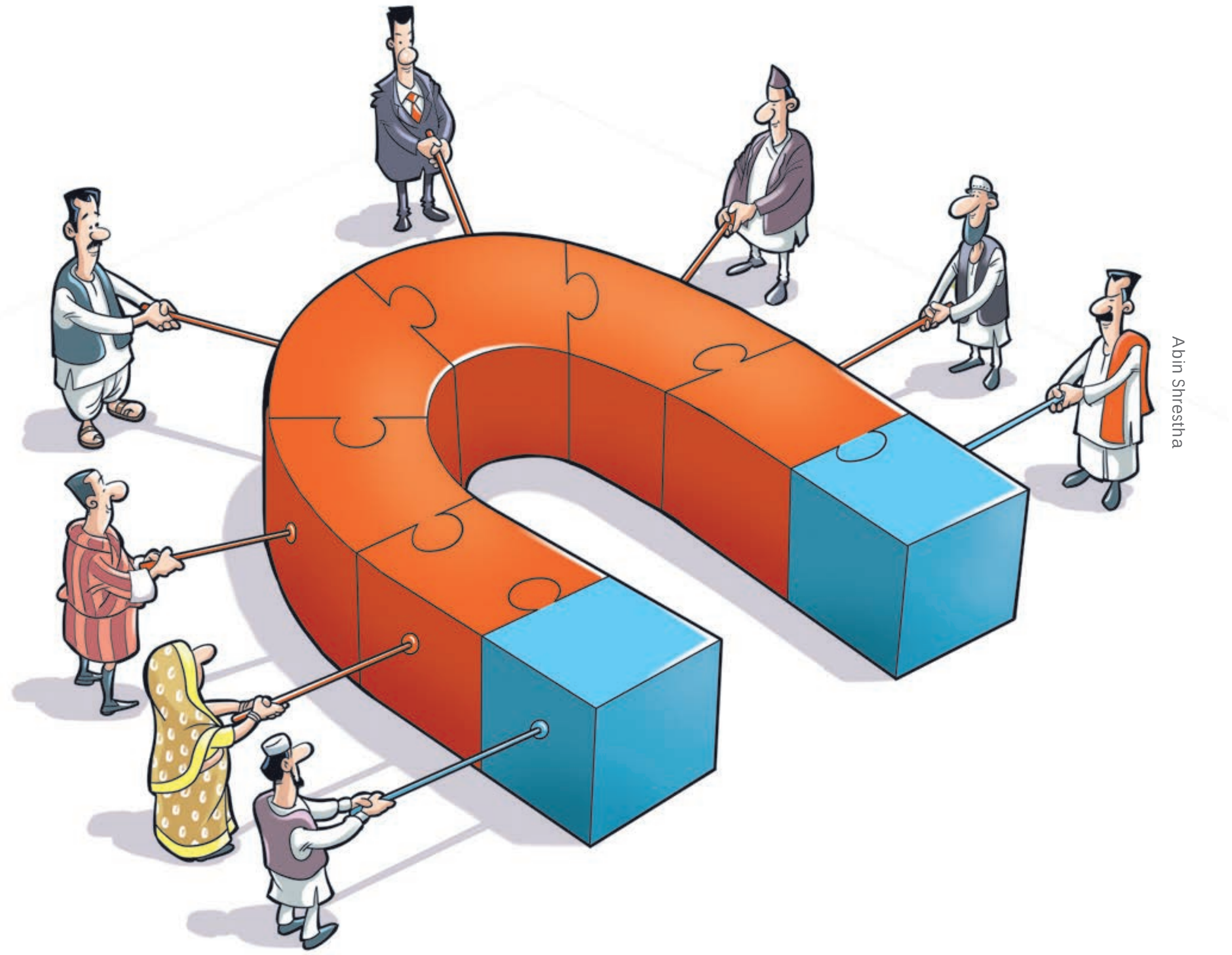
ISSUE brief

2022



Enhancing intraregional investment in South Asia

Kshitiz Dahal

South Asia is home to about 1.9 billion people, representing about a quarter of the world's population.[1] Furthermore, it is one of the fastest-growing regional economies. However, the region is one of the least integrated regions in the world. A serious attempt at regional cooperation and regional integration took place around 40 years ago, in 1985, with the establishment of the South Asian Association for Regional Cooperation (SAARC). However, this has not been able to bolster regional economic integration. One telling sign of poor regional integration is the low and stagnant intraregional trade—intraregional trade is estimated to be at one-third of the potential.[2] While the reasons for low intraregional trade have been the topic of many studies, these studies have focused on traditional barriers such as trade policy restrictions, the poor state of trade facilitation, and poor physical connectivity. A recent World Bank publication "Regional Investment Pioneers in South Asia"[3], drawing its insights from a bilateral investment dataset and a survey of 1,274 firms spanning eight countries in South Asia, sheds new light on the issue. It identifies low intraregional investment as a significant contributor to low intra-regional trade, and argues that poor knowledge connectivity is a fundamental attribute of the region that contributes to poor regional engagement, which is visible in the form of low intraregional investment and low intraregional trade.

Against this background, South Asia Watch on Trade, Economics and Environment (SAWTEE) organized a webinar on 1 December 2022 to develop a robust understanding of the topic of intraregional investment in South Asia. This issue brief presents the major ideas generated by the event, and hence is a recapitulation of the presentation (based on the World Bank publication "Regional Investment Pioneers in South Asia") and the ensuing discussion. As such, the brief also draws generously from the publication "Regional Investment Pioneers in South Asia" (henceforth, the 'investment study').

Low investment and intraregional investment characterize South Asia

The basic theoretical underpinning of investment is that investment contributes to capital accumulation, and in doing so augments productivity and contributes to economic growth. A basic characteristic of the global economy over the last few decades has been the mobilization of financial resources from across the border to meet investment needs. One such form of investment is foreign direct investment (FDI), whereby a foreign entity invests to create or acquire productive assets abroad, usually gaining controlling ownership of the said asset. In addition to the influx of financial resources, FDI could also result in the transfer of technology and management skills, and hence has been shown to enhance the competitiveness of the economy. Moreover, FDI is an important centerpiece in the modern economy characterized by the prominence of global value chains (GVCs)—the breakup of the production process across several cross-border locations but controlled by a lead firm. Evidence shows that GVCs contribute to enhanced competitiveness, employment creation, trade promotion, and economic growth, which makes the case for stimulating cross-border investments, including intra-regional investment. Furthermore, with studies showing the presence of trade-investment nexus, enhancing intra-regional investment also has the potential of increasing South Asia's sub-par intra-regional trade. In addition, investment promotion policies and activities, including those in South Asia, focus mostly on inward foreign direct investment (IFDI), while generally restricting or ignoring outward foreign direct investment (OFDI). However, as the investment study mentions, OFDI has several benefits such as enhancing the competitiveness of efficient firms, increasing profits through engaging in more profitable activities along the value chain, expansion of the scale and scope of output, creation of learning opportunities, better access to technology or brands, among others.


Pixabay

South Asia, however, exhibits a low level of global as well as intraregional investment. As per the investment study, South Asia's global FDI stocks amount to IFDI stocks of US$ 524 billion and OFDI stocks of US$ 82 billion (as of 2018), which are low compared to FDI stocks of other developing regions. Furthermore, intraregional investment is dismal—as highlighted by the study, the intraregional investment in South Asia, which amounted to US$ 3 billion (as of 2017), represents a meager 0.6 percent of its global IFDI stocks and 2.7 percent of its global OFDI stocks.

The current low level of intraregional investment, however, means that significant room exists for enhancing regional investment. Furthermore, COVID-19, coupled with other emerging trends such as digital revolutions, economic nationalism, and sustainability aspirations, foreshadows an acceleration of trends towards regionalization with its aspiration of shorter and resilient value chains; this increased regionalization will likely accelerate the shift from efficiency-seeking global value chains (GVCs) to regional market-seeking regional value chains (RVCs)[4]. Moreover, when sections of the world are seeking to diversify their supply chains from China, could South Asia merge as a viable alternative for this industrial relocation? This is possible through facilitating intra-regional investment, which will require alleviating the barriers to regional investment. The investment study has identified the restrictive investment regimes and weak knowledge connectivity as key barriers to intra-regional investment flows.

Policy regimes that constraint investment

Foreign investment regimes in South Asia show a significant variation but could generally be characterized as restrictive or lacking transparency with regard to outward investment and cumbersome with regard to inward investment (Figure 1). Bangladesh, Bhutan, and Nepal have restrictive outward foreign investment regimes—Bangladesh's outward investment regime, while undergoing relaxation, currently amounts to "cautious approval of a few investments, as well as several rejections"; Bhutan, in principle, allows OFDI, but the implementation, that requires multiple approvals, is highly restrictive; Nepal outright prohibits outward FDI. The outward FDI policies of Afghanistan and Maldives lack transparency; moreover, Afghanistan and Maldives do not promote or incentivize outward FDI. While India, Pakistan, and Sri Lanka explicitly permit OFDI through legislative provisions, Pakistan's OFDI arrangements lack transparency, and only India and Sri Lanka allow OFDI through 'automatic approval' routes. Furthermore, India is the only South Asian economy that actively promotes outward investment. With regard to inward investment, the policy regime in South Asia is improving, but still cumbersome when judged against the best practices. In the case of India, which has a relatively more open investment regime, there are region-specific policies in the case of both inward investment and outward investment. For instance, the inward and outward investment for all the neighboring countries with land borders are required to go through the approval route rather than the automatic route. Thus, in general, South Asia's investment regimes show a tendency to restrict outward FDI, and still lag behind global standards when it comes to inward FDI.

Figure 1 **Investment regimes in South Asia**

Outward investment regimes	• Restrictive: Bangladesh, Bhutan and Nepal • Lack transparency: Afghanistan, Maldives, Pakistan • Automatic approval: India, Sri Lanka • Region-specific policies: India
Inward investment regimes	• Improving but cumbersome by global standards, region-specific policies in India

Source: "Regional Investment in South Asia: Barriers, Opportunities and Facilitation", presentation made by Sanjay Kathuria at the webinar on 30 November 2022

Low knowledge connectivity and low trust constrain investment

Firms' international engagement is a complex process based on the knowledge and information about the destination country (for instance about markets, regulations, etc.). While adequate knowledge and information about the destination country can make the decisions related to engagement easier, the frictions in the flow of knowledge and information impede cross-border engagements. Furthermore, using a framework that treats knowledge as a fixed entry cost of cross-border investment, knowledge friction is a bigger impediment for investment than other forms of international engagement given that FDI decisions are less reversible than, for instance, trade and portfolio investment. Moreover, knowledge connectivity closely relates to trust, and consequently to network formations, which play a significant role in firms' potential of participating in cross-border trade and investment. Hence, understanding the state of knowledge connectivity in South Asia is imperative to enhance intra-regional investment flows. Furthermore, as mentioned in the investment study, knowledge connectivity merits a deeper investigation as the policies that are required to foster knowledge connectivity vary significantly from the ones required to solve the issues of traditional frictions to cross-border engagements.

The investment study compiles indicators of knowledge connectivity and bilateral trust, among others, to gain an understanding of the state of knowledge, information, trust, and network frictions in South Asia. A 'bilateral knowledge connectivity score' was computed based on firms' responses to the survey question about how well informed they were about the opportunities in South Asian economies abroad—the response would range from 1 (if the firm was "not at all" informed) to 4 (if the firm was "very well-informed"). The responses were clustered by origin country and destination country and the average of each cluster was computed to obtain origin-destination knowledge connectivity scores. The knowledge connectivity scores indicate weak knowledge connectivity among most origin-destination pairs (Figure 2). Furthermore, the average bilateral knowledge connectivity score across the region was 1.9—between "not at all" informed and "not very well-informed"—, indicating a general lack of knowledge connectivity.

In addition to low knowledge connectivity, the investment study finds that there also exists a polarization of knowledge connectivity—South Asian entrepreneurs display a higher knowledge about India's investment environment and that of one or two nearby countries, but show a significant dearth of knowledge about other countries in the region (Figure 1).

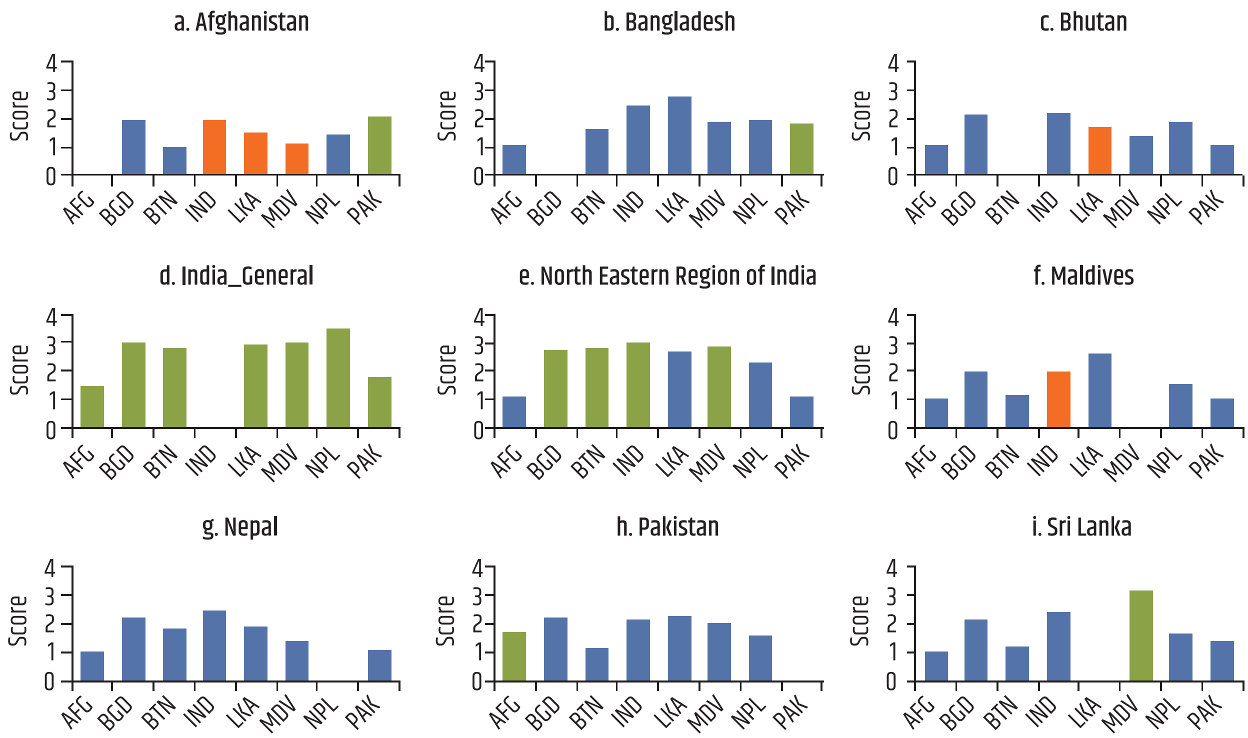
Employing a similar methodology as the one described above, the study computed 'bilateral trust scores' based on the firms' responses to the question about the level of trust they had in people from other South Asian countries. The bilateral trust scores exhibit significant variations across country pairs, with India identified as the most trusted country (Figure 3). However, an average bilateral score of 2.58—between "not that much" trust and "some trust"—indicates a low level of bilateral trust, although not much lower than the score of 2.84 computed for the EU-15[5], implying that the level of bilateral trust, albeit low, may be better than generally surmised. Nonetheless, the scores indicate a low level of bilateral trust, and the study's finding of a positive correlation between knowledge connectivity and trust suggests that bilateral trust deficits are likely driven by poor knowledge connectivity. This implies that enhancing knowledge connectivity could aid intra-regional investment flows by alleviating trust deficits. Moreover, the study also finds a low score for bilateral network connection, which could be the consequence of a low level of trust and information frictions. The bilateral network connection indicator, which measures "whether managers felt sufficiently well connected" in their social and business network contacts, finds network connection in South Asia similar to that of knowledge connection. The average bilateral network connection score of 1.85—between "not at all" and "not very well"—indicates a poor presence of meaningful business networks.

To sum up, the study finds significant knowledge barriers, trust deficits, and network frictions in South Asia, which limit cross-border regional engagements. According to the study, the major knowledge frictions are "lack of information about markets, potential partner firms, and regulations; lack of trust; potential lack of knowledge intermediaries; low productivity; low number of exporters; high trade cost; high communication costs; low access to finance; and need for risk appetite among potential investors." Any policy reforms initiated to stimulate cross-border investment will have to alleviate these sources of knowledge friction. Lastly, the low knowledge connectivity and bilateral trust are also indicative of the failure of the regional body (SAARC) in engineering a milieu of connectivity, including knowledge connectivity, and creating an environment of trust; the current moribund state of SAARC certainly doesn't help. Furthermore, the dearth of political commitment in this aspect is also to blame. Lastly, low private sector capacity, has also played its part.

Characterizing South Asian investment pioneers in the region

The investment study characterizes the outward investment entry decision of South Asian firms by estimating an empirical model (using data collected by the study from 1,274 firms),. Case studies of regional investment pioneer firms carried out by the study complement the findings by drawing insights about the investment decisions of entrepreneurs.

Figure 2 **Bilateral Knowledge Connectivity Scores, by destination**



How well informed do you feel about the opportunities abroad?
Note: Scores range from 1 (low) to 4 (high). Colored bars represent countries whose scores are 1 standard deviation above (green) or below (orange) the home country mean.
Source: South Asian Regional Engagement and Value Chains Survey in "Regional Investment Pioneers in South Asia", 2021

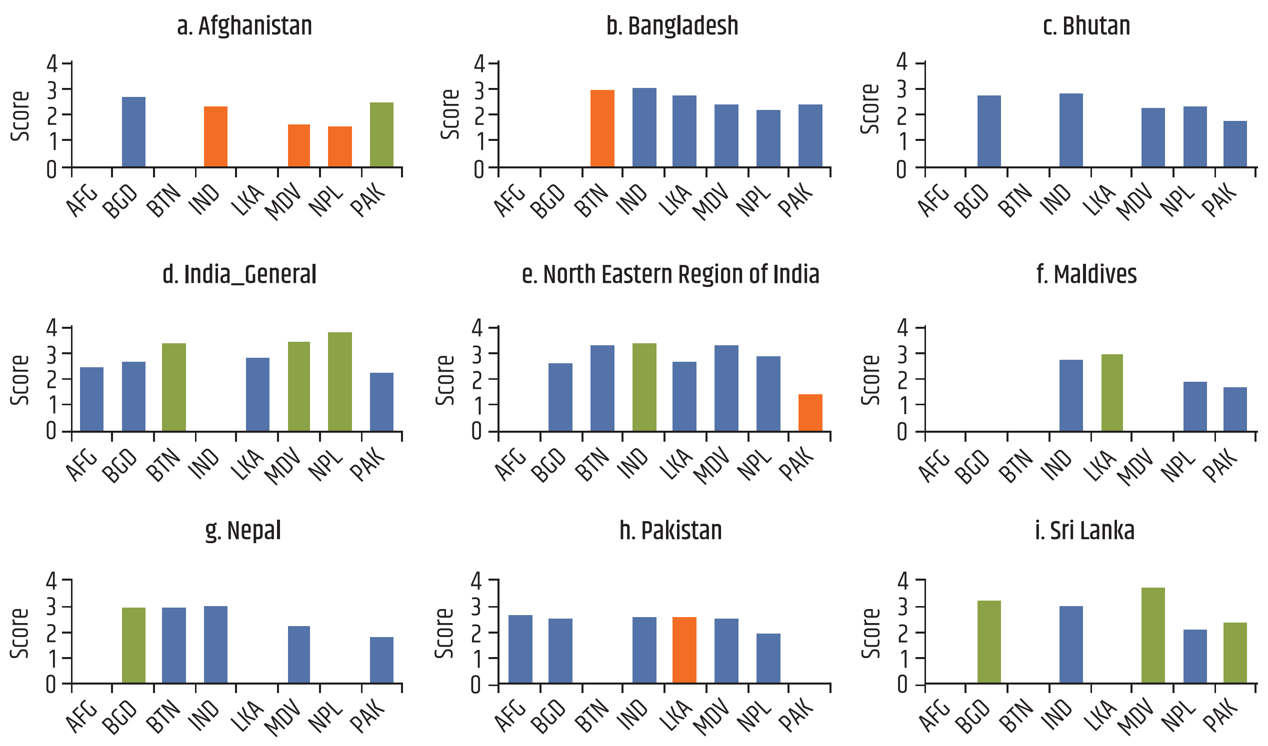
Consistent with the theoretical frameworks, the empirical model finds that in South Asia high-productivity firms with investible reserves are generally the firms that invest abroad. Furthermore, it finds that proximity matters in investing decisions, a case in favour of intra-regional investment. Moreover, the empirical model finds that networked firms, primarily the ones where founders or chief executive officers have ethnic or social networks abroad, are more likely to invest abroad, highlighting the importance of knowledge connectivity. The finding suggests that knowledge connectivity can make cross-border investment more inclusive—even medium productivity firms may invest in regional markets if they are able to overcome knowledge and information frictions, for instance, through their networks.

More importantly, the study shows that South Asian investment pioneers tend to follow a gradualist path. Particularly, the investment pioneers are likely to start their cross-border engagement through exporting experience. Exporting could act as a relatively low-cost cross-border engagement than investment, but the acquisition of knowledge about the market in the process, and possibly network formation, could enhance the possibility of investing abroad. Furthermore, the pioneer firms could be a source of information for other follower firms, thereby reducing their entry costs and hence enhancing their investment likelihood. These findings have important implications for firms, one of the foremost being taking a gradualist approach to investment by starting with small steps, for instance, exporting, and then accumulating learning to gradually engage in more sophisticated cross-border engagements. Likewise, the implications for firms, highlighted in the study, include the importance of investment in enhancing knowledge connectivity, including in network formations; the possibility of using the region as a springboard for experimental investment; and the positive roles that knowledge intermediaries could play in facilitating investment. Moreover, these findings of what drives cross-border investment decisions among South Asian firms also have important policy implications for enhancing intra-regional investment.

Policy implications

The findings of the study, particularly the poor state of knowledge connectivity, restrictive FDI regimes, and the determinants of investment by regional pioneers, have policy implications along the following four major areas.

Figure 3 Bilateral Trust Scores, by destination



How much trust do you have in people from various South Asian countries?
Note: Scores range from 1 (low) to 4 (high). Colored bars represent countries whose scores are 1 standard deviation above (green) or below (orange) the home country mean.
Source: South Asian Regional Engagement and Value Chains Survey in "Regional Investment Pioneers in South Asia", 2021

Pixabay

Enhancing knowledge connectivity: Given that knowledge and information frictions are shown to have strong inhibiting impacts on investment decisions, policies and initiatives that promote information dissemination and network development such as match-making events, and support for regional business associations, including cross-border women's networks, can promote investment. Furthermore, facilitating the transfer of knowledge of industry veterans and regional investment pioneers could help resolve knowledge and information frictions.

De-regulating OFDI regimes: Given that South Asian OFDI regimes are generally restrictive and lack transparency, there is a need to create an understanding that OFDI is integral to firms' international engagement and as such vital in enhancing the competitiveness and resilience of firms. For countries that have strict OFDI regimes out of concerns such as capital flights and pressure on forex reserves, outward FDI could be relaxed gradually and selectively, on a pilot basis.

Developing smart IFDI promotion policies: Given that current South Asian inward FDI regimes, although improving, are cumbersome by global standards, smart inward FDI policies such as those that focus on reducing entry costs could enhance investment. For instance, it may be pragmatic to seek out and target foreign investors that are already present in the region given that they have already incurred the high entry cost of investing in the region.

Enhancing digital connectivity: The study suggests that reduced trade costs can enhance investment. Enhancing digital connectivity offers a quick and cost-effective way to reduce trade costs and hence could be an important measure to increase investment flows.

Conclusion

South Asia exhibits a weak economic linkage among its countries. For instance, the region has a relatively low FDI stock, both inward and outward, when compared to other developing regions. The regional investment study conducted by the World Bank identifies the investment policy regimes in South Asia as one of the reasons for low intraregional investment. More importantly, the study finds a low level of knowledge connectivity in the region, which is a significant impediment to regional cross-border investments. The study's findings have important implications for firms as well as for governments, which could be summed up as "the payoff of knowing your neighbors" is high when it comes to enhancing investment flows. ■

Notes

1 South Asia in this paper represents eight countries: Afghanistan, Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, and Sri Lanka. These countries are also the member states of the South Asian Association for Regional Cooperation (SAARC), a regional intergovernmental organization.

2 Kathuria, Sanjaya, editor. 2018. *A Glass Half Full: The Promise of Regional Trade in South Asia*. Washington, DC: World Bank.

3 Kathuria, Sanjay, Ravindra A. Yatawara, and Xiao'ou Zhu. 2021. *Regional Investment Pioneers in South Asia: The Payoff of Knowing Your Neighbors*. Washington, DC: World Bank.

4 UNCTAD. 2020. *World Investment Report 2020: International Production Beyond The Pandemic*. New York: United Nations Publications.

5 The score for EU-15 was computed using the same question but a different data collection method—the EU-15 data was collected through a random sample of the general public, whereas the South Asian score in this study was computed from non-random data collected from businesses.

This issue brief is prepared by Mr. Kshitiz Dahal, Senior Research Officer, SAWTEE. It is based on the discussions in a webinar on "Regional Investment: Barriers, Opportunities and Facilitation", organized by SAWTEE in collaboration with The Asia Foundation (the Foundation) on 1 December 2022. Prof. Sanjay Kathuria presented at the event, and the discussants included Prof. Mustafizur Rahman, Prof. Sanjeev Mehta, Mr. Radhesh Pant, Dr. Vaqar Ahmed, and Ms. Subhashini Abeysinghe. The brief also derives generously from the World Bank publication "Regional Investment Pioneers in South Asia: The Payoff of Knowing Your Neighbors" authored by Sanjay Kathuria, Ravindra A. Yatawara, and Xiao'ou Zhu. Views expressed are those of the author and do not necessarily reflect the position of SAWTEE and its member institutions, or the Foundation.

sawtee
www.sawtee.org

P.O. Box: 19366
Tukucha Marg, Baluwatar, Kathmandu, Nepal
Tel: +977-1-4424360/4444438, Fax: +977-1-4444570
E-mail: sawtee@sawtee.org

Design: Bipendra Ghimire

South Asia Watch on Trade, Economics and 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.