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Determinants of FDI in South Asia

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Abstract

Since the early 90s the countries of South Asia have embarked upon a process of reform and liberalization to open up their economies to foreign investment. Foreign direct investment is seen as a very important parameter in accelerating the process of growth and development in these developing economies and hence, is an important priority for the governments of these nations. A series of initiatives have been undertaken by these countries over the last 20 years to increase the inflow of FDI. But it's very important to understand the precise set of policy measures that can create maximum and help these countries in achieving their goals. This report analyses the determinants of FDI in South Asia. Six countries – India, Bangladesh, Pakistan, Sri Lanka, Nepal and Maldives were studied and GDP, Direct Investment, Trade Openness, Real Effective Exchange Rate, Interest Rate and Labour are the parameters taken into consideration. The time period of the study is 1990 to 2010. The econometric results show that Trade Openness, GDP and Direct Investment have a positive impact on FDI whereas Labour had a negative influence. These results can be justified by studying the political and economic developments over the past 20 years. Therefore, if the countries of South Asia want to continue to attract FDI they should focus on bolstering the GDP, strengthening the level of direct investment to improve the infrastructure available and focus on increasing trade openness wherever possible

Keywords: FDI, South Asia, GDP, Direct Investment, Trade Openness, Labour.

Introduction

One of the remarkable features of globalization in the 1990s was the flow of private capital in the form of foreign direct investment. FDI is an important source of development financing, and contributes to productivity gains by providing new investment, better technology, management expertise and export markets. As a result of this FDI inflow, countries all over the world are witnessing better growth prospects and a strengthened economy. South Asian countries like India, Pakistan, Bangladesh, Nepal and Sri Lanka have followed a liberal approach towards FDI and witnessed significant volumes of FDI inflows mainly due to market size and labour resulting in economic development[1]. In our study, we have focused mainly on the South Asian countries and especially India. The various factors which make South Asia an attractive location for new investment projects have been thoroughly analyzed. All the South Asian countries have been following consistent economic reform policy measures emphasizing the market economy and aimed at integrating their economies with the rest of the world.

The components of analysis includes the detailed description of the various trends and patterns of FDI inflow in South Asia, the different policies and incentives given by govt. to attract FDI, the various determinant factors of FDI and the explanation of how an increased FDI inflow brings about better growth and development in a particular nation, with special reference to Indian economy. Also, various case studies and comparative analysis have been included to understand why India lags behind the developed nations and what more could be done to increase the foreign investment opportunities.

India, with its relatively well developed financial sector, strong industrial base and critical mass of well educated workers, appears to be well placed to reap the benefits of FDI. Various studies have projected India among the top 5 favoured destination for FDI. Cumulative FDI equity inflows has been Rs.554,270 crore (1,27,460 Million US$) for the period 1991-2009. This is attributed to contribution from service sector, computer software, telecommunication, real estate etc.

India's 83% of cumulative FDI is contributed by nine countries while remaining 17 per cent by rest of the world. Even after all these impressive statistics, India still has a long way to go to match up the kind of development and economic growth happening in the developed nations. While India has an overall market-friendly and liberal policy towards foreign investment, foreign capital still does not enjoy equally porous access in all parts of the economy. Fairly unhindered access to manufacturing and is accompanied by conspicuous lack of access in certain services like insurance and agriculture. Maximum FDI has taken place in the service sector including the telecommunication, information technology, travel and others[2]. In view of this, it is appropriate that Indian policy makers continue to make efforts to make India an attractive destination for FDI. India's future foreign investment policy faces the critical challenge of increasing access of foreign capital to these segments for enhancing inward FDI.

Range	Inflows	Outflows
Above $10 billion	India	India
$1.0 to $9.9 billion	Islamic Republic of Iran, Pakistan, Bangladesh	..
S0.1 to $0.9 billion	Sri Lanka, Maldives	Lslamic Republic of Iran
Below $0.1 billion	Nepal, Afghanistan, Bhutan	Pakistan, Sri Lanka, Bangladesh

Figure-1
India is clearly the regional leader in South Asia; Source: UNCTAD – Regional Trends in FDI

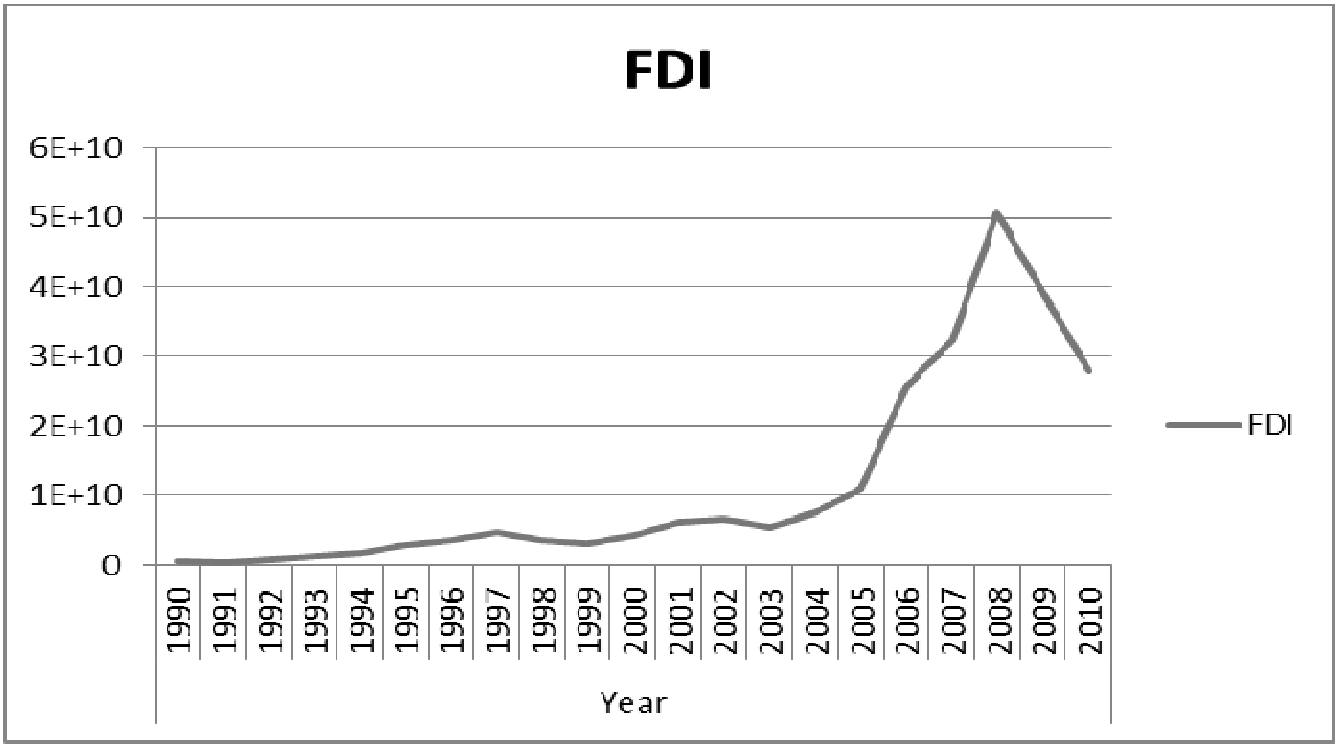

Figure-2
FDI Inflow in Current US$

A series of initiatives have been undertaken by these countries over the last 20 years to increase the inflow of FDI. But it's very important to understand the precise set of policy measures that can create maximum and help these countries in achieving their goals. There exists a research gap in this area and our study aims to deal with the issue.

This research paper has the following objectives – i. To analyze FDI in South Asia – India, Pakistan, Bangladesh, Sri Lanka, Nepal and Maldives. ii. To study the impact of GDP, Capital Formation, Interest Rate, Labour, Real Effective Exchange Rate and Trade Openness on FDI through econometric analysis.

Research Methodology

The study analyses the parameters which impact FDI across six South Asian countries – India, Pakistan, Bangladesh, Sri Lanka, Nepal and Maldives.

Since FDI in South Asia has shown tremendous increase from early 1990s, the time period of the study is 1990 to 2010. The data has been taken from UNCTAD and World Bank.

First, we test the data for stationarity using augmented dicky fuller test. Then, we carry out autocorrelation checking using Durbin Watson test. Next, we check for multicollinearity using white test. After checking the integrity of the data we run the OLS regression on the pooled data of the six countries being considered.

The variables which have been considered as the determinants of FDIs at macro level are, GDP, domestic capital formation (DI), interest rate (IR) and real effective exchange rate (REER) labour (LAB) and trade openness (TO).

Table-1
Econometric Results

Variable	Coefficient	Std. Error	t-Statistic
LOGGDP	1.480917	0.399159	3.71009
DILOG	0.836387	0.372192	2.247189
LABLOG	-1.201622	0.240979	-4.98643
IR	-0.005584	0.023015	-0.242617
TO	0.006472	0.008591	0.753345
REER	-0.023445	0.009245	-2.535825

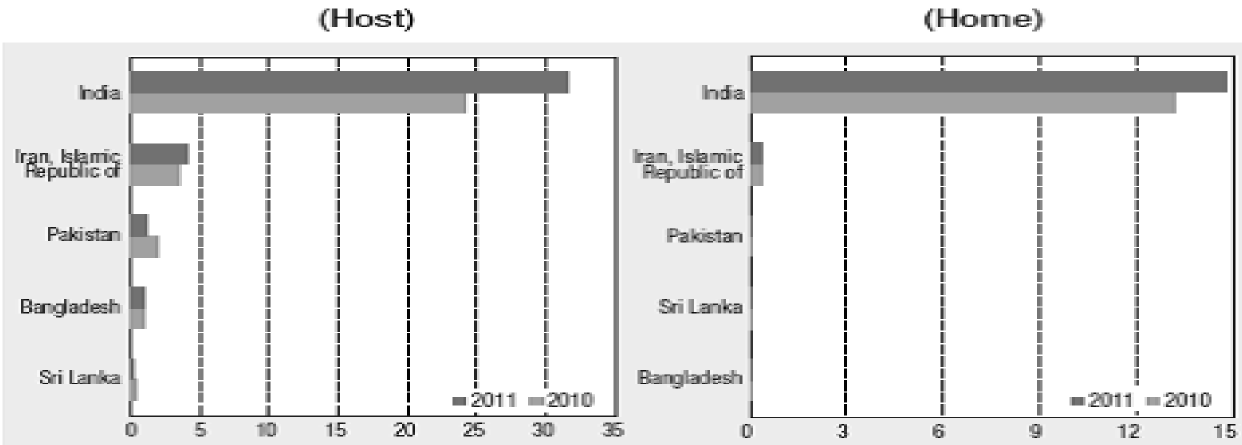

Figure-3
FDI Flows 2010-11; Source: UNCTAD - Regional Trends in FDI

Results and Discussion

The countries included for analysis are Bangladesh, India, Maldives, Nepal, Pakistan and Sri Lanka.

The model used is: ln FDI= α0 + α1 ln GDP +α2 ln DI+α3 REER+α4IR+α5TO+α6 ln LAB

Where DI is Direct Investment (Capital Formation), IR is real interest rate, REER is real effective exchange rate, TO is trade openness and Lab is labour force.

Pooled Least Square method was used to determine the various coefficients of the parameters used to estimate the FDI inflow in South Asia.

At 5% level of significance only GDP, REER, direct investment and labour were found to be significant parameters.

Furthermore GDP and direct investment have a positive impact on FDI inflows while labour and REER has negative influence.

As shown by the figure above, India is by far the most influential nation in South Asia. Currently, India accounts for about 80 percent of the region's GDP, Pakistan accounts for about 10 percent, Bangladesh 6 percent, Sri Lanka 2 percent, and the rest less than 2 percent. The policy measures adopted by India are likely to have a very high impact on the region's FDI. Hence, we begin our analysis by understanding the evolution of India's trade policies and its integration with the world economy.

The Indian economy was a closed economy with low international trade, high tariff and non-tariff barriers, and a tightly controlled capital account till the liberalization in early 1990s. The reforms included a unified exchange rate system, lowering of tariffs across the board, and substantial reductions in regulation of, and restrictions on, trade. The results of the liberalization were a large increase in exports, imports, and foreign direct investment (FDI), with external debt declining and foreign reserves recording strong improvements.

Exports growth doubled in the first ten years after the reform, from an annual growth of around 11.4 percent average during 1995–2000, to 25 percent by 2006 Services exports, especially software and information technology (IT), also grew rapidly[3]. Exports of goods and services now account for around 22 percent of India's GDP, up from around 8 percent at the eve of the reforms. Imports have also grown remarkably, reflecting India's growing integration with the global economy. Increase in trade openness is clearly a significant determinant of FDI in India.

Interestingly, the destination and source of India's trade have also become more diverse since the mid- 90s. While in the early part of India's transformation Europe and other advanced economies accounted for a large share of India's trade, in the past decade the share of trade with Asia, Africa and the Middle East has grown significantly, surpassing that of the advanced economies.

At the beginning of India’s transformation, the key contributors to export growth were food and beverage categories, but twenty years later India’s exports are led by services. India’s exports of IT have grown consistently above the global average since 2000, and the share of services in India’s exports has been much higher than in most comparator countries. Between 1995 and 2010, India’s share of services exports in world trade more than quadrupled, while goods exports only doubled.

Maldives: Foreign Direct Investments (FDI) has always played a crucial role in the economic development of the Maldives. The Government acknowledges the importance of foreign investment and recognizes its contribution to economic development and employment creation. In 2006, World Bank ranked Maldives the highest in the region in its “Ease of doing business Index”.

The success of foreign investments in the Maldives can be attributed to its open and liberal economic environment, relative political stability and the consistent growth of the economy, which has achieved an average annual growth rate of 7.5 percent over the last 15 years. Foreign investors are offered a simple and transparent policy environment and continuous efforts are being made to make the investing environment more predictable and transparent.

Capitalizing on the numerous benefits of investing in the Maldives, many reputed international brand names have established their investments in the country. Amongst them are world class resort investments by international hotel chains such as Hilton, Four Seasons, One and Only, Club Med and numerous other regional brands. Other foreign investments in the Maldives are concentrated in the transport and telecoms sectors, water production and distribution, and in the financial sector. Many global brand names, such as Hong Kong Shanghai Banking Corporation (HSBC), Ernst and Young (EandY), Price Waterhouse Coopers (PWC), KPMG and many reputed insurance providers have strongly established themselves in Maldives.

Incentives for foreign investors: i. There is no income tax, corporate tax or property tax in the Maldives. ii. Right to100% foreign ownership. iii. Legally backed investment guarantee. iv. Provision for overseas arbitration of disputes. v. Long term contractual agreements and long term lease of land. vi. Freedom to use foreign managerial, technical and unskilled workers. v. No foreign exchange restrictions. vi. No restrictions on the repatriations of earnings or profits.

Nepal: The flow of FDI into Nepal hasn’t been smooth over the years. The flow of inward FDI was at peak during mid- 1990s and thereafter declined due to country’s civil war of Maoist insurgency. However, as Maoist ended up the decade’s civil war and joined the Government, Presently Nepal is creating a peaceful environment for the Foreign Investors. The political disputes are cooling, and several foreign investors are keeping an eye to Nepal. Nepal’s FDI projects include mostly in manufacturing, hydropower, mineral exploitation, construction, agro based, chemicals, tourists hotels and restaurants, specialized services and in food and beverage industries.

In context to approved FDI projects, more than 40% of investment comes from India. Nepal has been widely entertaining most of its FDI in Manufacturing industries. The low labour cost might have pursued it. More than 32% of its total investment has been only in Manufacturing projects. Some of globally renowned companies operating are 'British American Tobacco (BAT)', Unilever and Coca-Cola.

Government of Nepal has adopted an open and liberal policy to lure foreign investors. The industrial policy and the Foreign Investment and Technology act, 1981 initially paved the way towards inward FDI throughout Nepalese economy. stated more emphasizes went to industry and trade sectors aiming private sectors to entertain a dominant role. Government would act merely as a mediator providing infrastructure and productive environment for investment. The FDI act 1981 does not seem to be productive as only few countable investments were procuring. The government then reformed the act in 1992 formulating Foreign In-vestment and One Window Policy. Hence, the Foreign Investment and Technology Act 1992 and Industrial Act, 1992 introduced. The policy liberalization of 1992 and a renewed trade treaty with India during 1996 dramatically increase the proportion of FDI to Nepal.

But the flow of inward FDI in Nepal is very modest compared to other south Asian countries. FDI Inflows to Nepal were the second lowest in South Asia in 2010. Nepal has not yet lured investors towards it comparing to other South Asian countries. India, Pakistan, Bangladesh, etc have more inward FDI than Nepal. Despite of having enough natural resources and scenic beauty, Nepal has failed to put attention to foreign investors. The key challenges have been political instability, power crisis, poor governance, labor unrest and high transaction costs[4]. Nepal received nearly 3 percent of shares (South Asia) in 1990, which is the highest of all time. Though it declined from 1992, the graph stood slowly in the mid=1990s. After 2003, the graph slinked as the country smudged in civil disputes surrounding unsuitable and loud environment. However, with the betterment of the political environment FDI graphs are slowly awakening from zero level. In 2010, Nepal’s received 0.4 percent of South Asian FDI share.

Bangladesh: Bangladesh has focussed heavily on improving trade relations with its neighbours and has consistently pursued favourable trade policies to strengthen and bolster its economy. Bangladesh enjoys a huge transportation advantage because of its geographic location and the waterways have enabled it to have flourishing trade relation with India, Myanmar and the

Yunnan province of China in particular. Since Bhutan and Nepal and are landlocked countries, most of the trade that Bangladesh has with these countries happens through India.
Cost effective labour and the presence of an immense market which is very easily accessible has also helped bring in additional FDI into Bangladesh. With continued efforts and a progressive outlook Bangladesh is very likely to prosper in the company of its more influential neighbours.

Pakistan: Pakistan ranks amongst the top seven fastest growing economies of Asia and offers the advantage of cheap labour. Although agriculture is still the mainstay of the economy and employs 48% of the work force, its share in the gross domestic product (GDP) is 21.6%. Thus, clearly, there has been a paradigm shift towards manufacturing and service industries like IT and Telecom. The primary and services sector have received FDI resulting in growth and growth has helped in FDI in manufacturing sector[5]. Regional tension and political instability have obviously deterred foreign investors from venturing into Pakistan but the country still houses 600 MNCs. The government of Pakistan desires to encourage foreign and domestic investors in the country and says that there is no restriction on investment in any sector in Pakistan.
Earlier in 2012, in a move that will strengthen commercial ties between India and Pakistan, Reserve Bank of India has permitted foreign direct investment from Pakistan into India which had been banned hitherto. The central bank said "a person who is a citizen of Pakistan or an entity incorporated in Pakistan may, with the prior approval of the Foreign Investment Promotion Board of the Government of India, purchase shares and convertible debentures of an Indian company under Foreign Direct Investment Scheme". The central bank added that this notification overrides the earlier regulation under the foreign exchange management act which bars citizens of Pakistan or any entity incorporated outside India in Pakistan from purchasing shares or bonds of an Indian company under the foreign direct investment scheme. This move will increase FDI flows and go a long way in improving the trade relation between the two neighbouring countries. Both the countries have a lot to gain from each other and this new decision is likely to unlock the tremendous potential gains that were waiting to be realized until now.

Sri Lanka: Sri Lanka offers attractive investment opportunities for foreign companies and has adopted a number of policies to attract foreign direct investment into the country and the country seems to offer perhaps one of the most liberal FDI regimes in South Asia. As a result, during the last decade FDI inflows in Sri Lanka has increased considerably and has helped the nation not only by supplementing domestic investment, but also in terms of employment creation, transfer of technology, increased domestic competition and other positive externalities.

But Sri Lanka also has a lot of untapped potential with regard to the resources at its disposal, strategic location and proximity to an economic giant like India. The investment climate is not optimum as a result of lack of good governance, corruption, political instability and disturbance, bureaucratic inertia, and poor law and order situation.

Conclusion

Six South Asian countries – India, Bangladesh, Nepal, Pakistan, Nepal and Maldives were considered for our study of FDI's determinants. The econometric results show that Trade Openness, GDP and Direct Investment have a positive impact on FDI whereas Labour had a negative influence. These results can be justified by studying the political and economic developments over the past 20 years.

The negative influence that labour has on FDI can be explained by the fact that many developed countries have become very insecure about outsourcing off late. The presence of cheaper labour in the South Asian makes it a very attractive destination for business process outsourcing and cost-effective mass manufacturing. But since this has led to a rise in unemployment in the west, the governments of these countries have been discouraging the aforementioned outsourcing thus pulling down the level if FDI in South Asia.

GDP and direct investment have a positive impact on FDI inflows. This is naturally expected as growth in FDI and increased direct investment helps create an environment conducive to productive use of FDI. This encourages the foreign investors to pump in more money as they feel that the infrastructure that they need to ensure healthy return on investment will be in place.

The government's stance on key issues is also a very important parameter and as we have seen above, most of the South Asian countries are very keen on attracting FDI and since the 1990s have been increasingly open to trade. This positive stance taken by the policy makers of the South Asian countries has encouraged foreign investors to enter the region and hence, trade openness shows a positive impact on FDI.

Thus, if the countries of South Asia want to continue to attract FDI they should focus on bolstering the GDP, strengthening the level of direct investment to improve the infrastructure available and focus on increasing trade openness wherever possible.

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