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Trends and Determinants of Foreign Direct Investment in South Asia

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Executive Summary

- Like many other developing countries, South Asian nations have been experiencing increased FDI inflows over the past decade as developing countries get a larger share of cross-border investments once sent to developed countries.[1] Nonetheless, South Asia's FDI inflows remain the lowest relative to GDP among developing country regions. Of the inflows that do reach South Asia, India dominates, with much of the inflow reaching the service sector and very little going into industry, agriculture, or mining.

- Compared to other regions, South Asia has very little cross-border investment from within the region. Two factors are at work—high overall regulatory restrictions on FDI and specific restrictions placed on doing business with other countries in the region. Also limiting FDI flows are overall trade restrictiveness that reduces the benefits to cross-border investments and weak institutions to protect foreign investors and facilitate investment.

- For South Asia, the potential for faster growth in intra- and inter-regional FDI flows is significant. The key factors leading to this conclusion are South Asia's current low levels of FDI, the many unexploited opportunities for embodied knowledge transfer, and supply-chain linkages. Liberalizing policy constraints in both trade and foreign investment, keeping corporate tax rates competitive and low, and improving governance and transparency could help to substantially improve FDI flows.

Introduction

Over the next 20 years, more than 1 million new workers will be entering the South Asian labor market each month as the region's youth bulge matures and seeks employment. To absorb these workers and provide higher living standards and reduce poverty, South Asian countries will have to rely on more than just public investment. It's just not feasible to provide all the economic capacity for more and better jobs through the government sector at a time when budgets are already under pressure and debt levels are relatively high. The private sector will have to play a key role in creating productive jobs for the new labor force entrants, and a critical element of this is improving the economic climate to attract private investment, a vital factor in sustainable and broad-based growth.

While greater domestic private sector investment is important, no country has moved into middle- or upper-income status in isolation. Foreign private capital flows—bank lending, direct investment and

[1] South Asia Region refers to Afghanistan, Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, and Sri Lanka.

portfolio investment (i.e., debt and equity)—expand the potential sources of capital available to countries, raising productivity and boosting growth. Studies find that foreign direct investment (FDI) has a potentially large role in this due to its relative stability (Levchenko and Mauro 2007) and its impact on transfers of knowledge and technology (Moran, Graham and Blomström 2005). Empirical evidence points to FDI's productivity-enhancing effects in advanced economies—on average a 1.3 percent increase in country-wide total factor productivity growth has been associated with a 10 percent increase in FDI—although the impact varies by country (Bitzer and Görg 2009). Other research indicates similar outcomes in developing countries: the Czech Republic, Russia (Sabirianova Peter, Svejnar and Terrell 2005), Indonesia (Blalock and Gertler 2004), Lithuania (Javorcik 2004), among others. Blonigen and Wang (2005) find that FDI flows to developing countries, as opposed to developed countries, have a particularly strong effect on growth by crowding-in domestic investment, and Kee (2011) shows that direct and indirect spillovers can be quite strong as demonstrated by the case of Bangladesh (see Box 2).

This report looks into the historical patterns of FDI in South Asia, examines its sectoral composition, and evaluates current policies and policy options that may help create an environment for increasing FDI flows. The launching point for this study is the substantial empirical literature that suggests that FDI is associated with growth, development, and productivity enhancement. The goal of the study is modest in that it does not seek to estimate the size of FDI spillovers on productivity growth, or address whether governments should actively subsidize FDI inflows over domestic investment as a means to enhance growth, but rather to understand whether the level of FDI flows as a share of GDP, its sectoral composition, and intra-regional flows are comparable to other developing regions and, if not, what might be some of the impediments to these flows.

While FDI flows have increased over the past decade to South Asia, particularly from developed countries to South Asian service sectors, it has lagged in other sectors and remains relatively low overall. One of the region's bright spots has been the increase in FDI flows within South Asia and from other developing countries outside the region. In other words, the traditional pattern of capital flows going in one direction—from rich to poor countries—is changing, with an increasing flows and technology exchange taking place between developing countries themselves. This reflects the more integrated and diversified nature of capital markets and the changing nature of the global economy, where the center of gravity in economic activity has gradually shifted toward developing countries.

By examining the historical patterns of South Asia's FDI, the policy environment, and the connections between the two, this study will provide the context for policy makers to better identify

strategies easing constraints to FDI and for boosting potential broad-based growth in the region. As noted by Blonigen and Wang (2005), countries that attract strong FDI flows typically have a host of favorable policies—for example, strong property-rights protection, stable macro policies, adequate infrastructure, and a clear and competitive regulatory environment—which can crowd-in domestic investment and improve overall productivity. This study will identify which factors and constraints matter the most in determining intra- and inter-regional FDI flows in South Asia.

We begin the analysis by providing an overview of the global trends in FDI and how South Asia compares to these trends. We show that FDI (both inward and outward) has grown quite substantially over the last decade for all developing countries and FDI dominates portfolio flows as a source of investment for developing countries. Moreover, FDI inflows have been relatively more stable than portfolio inflows.

We next examine the trends in South Asia's inward and outward FDI flows as a share of GDP and show that South Asia ranks quite low compared to other regions. Of the flows that do arrive, a large portion is associated with investment in the service sectors, with India accounting the majority of the absolute flows. Relative to GDP, however, India does not stand out as a large recipient. Interestingly, while the number of developed countries investing in South Asia has remained roughly the same over the last decade, the number of other developing countries investing in South Asia has almost doubled—suggesting greater South-South linkages. Intra-South Asian FDI flows remain quite small, particularly because the two largest South Asian countries, Pakistan and India, maintain strong restrictions on investments from each other.

Following this, we examine policy, legal, and regulatory investment issues in South Asia to better understand overall incentives and disincentives to FDI inflows and outflows in the region's institutional framework. Overall, positive changes have taken place over the past few decades, while restrictions on FDI differ substantially among countries in South Asia. India's progress on FDI-promoting policies has accelerated in recent years to make FDI policies more transparent, predictable, and simpler. Many other countries have also taken steps to improve transparency in regulations and reassure investors about the security of their investments in the country. Nonetheless, restrictions on outward FDI and capital account restrictions remain, and behind the boarder constraints to investing, such as clear and enforceable contracting, remain a challenge for foreign investors and domestic investors alike.

Finally, the paper examines the determinants of FDI growth in South Asia. We find that there is a high potential for larger flows due to South Asia's current low levels of FDI, as well as opportunities for liberalizing policy constraints in both trade and foreign investment. Lowering corporate tax rates and improving governance and transparency would also be important contributors to increasing the growth in FDI/GDP. Making progress on all of these areas could help to substantially improve FDI flows into South Asia and enhance the region's growth and productivity, as indicated by the experience of other regions.

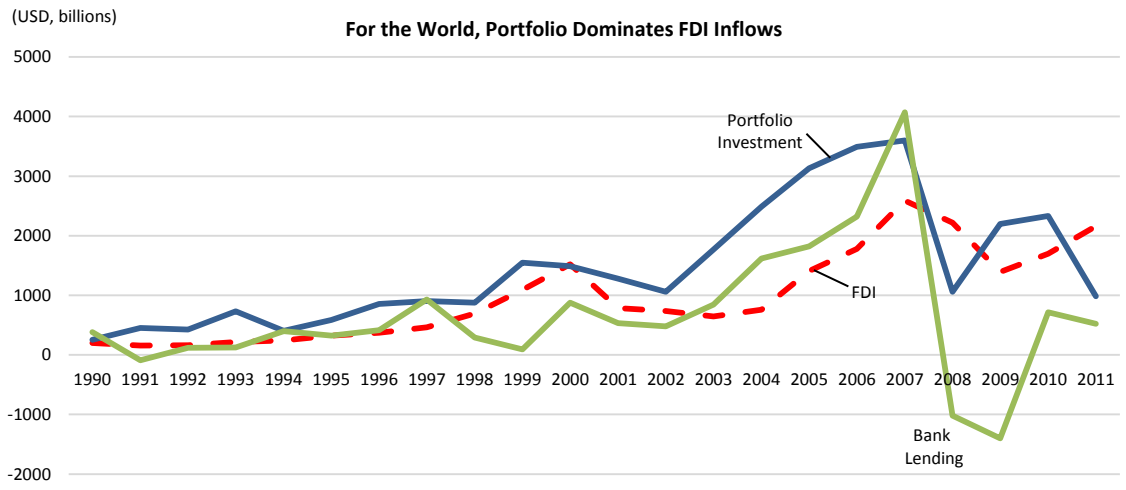
Global FDI and South Asia's FDI Experience

Global FDI has increased substantially since the 1980s, and it is now among the largest forms of cross-border capital flows. World FDI inflows totaled US$1.4 trillion in 2010, 27 times larger than the 1980s FDI of US$53 billion. Relative to GDP, FDI has grown fivefold. Since the early 1990s, private capital inflows, mostly in the form of FDI, have become a major factor in development, exceeding official foreign assistance provided to developing countries.

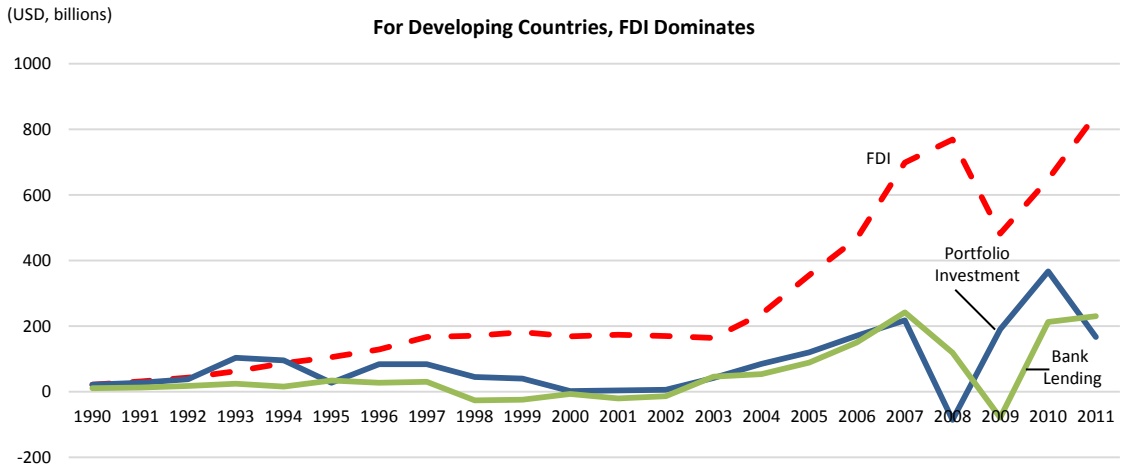
Developed countries continue to be major source of FDI to developing countries, although the trend is changing as more FDI moves between the developing countries themselves. Except for a few brief periods, portfolio flows (both debt and equity) and bank lending have exceeded FDI for the world as a whole during the past two decades. However, FDI has risen to dominate among developing countries (Figure 1). FDI inflows have also been a relatively stable form of investment (Box 1).[2] Growing international capital flows have become an increasing share of employment in developing countries, including those in the South Asia region. Globally, employment in wholly or partly foreign-owned companies has increased in the recent years, accounting for 69 million jobs in 2011, an 8 percent increase over the previous year. By contrast, overall job growth in the same period was 2 percent (UNCTAD 2012).

[2] "FDI inflows" are defined as net investments in domestic firms by foreigners. This is a different concept then "net" FDI (net investment in domestic firms by foreigners minus the net purchases of foreign firms by domestic agents). (Broner, et al. August 2011) find that "gross" capital flows tend to be more volatile than "net" capital flows. When foreigners invest in a country, domestic agents tend to invest abroad, and vice versa. Gross capital flows are also pro-cyclical, with foreigners investing more in the country and domestic agents investing more abroad during expansions. During crises, especially during severe ones, there is a retrenchment in both capital inflows by foreigners and capital outflows by domestic agents.

Figure 1: Foreign Direct and Portfolio Investment Inflows



Source: BOP, IMF

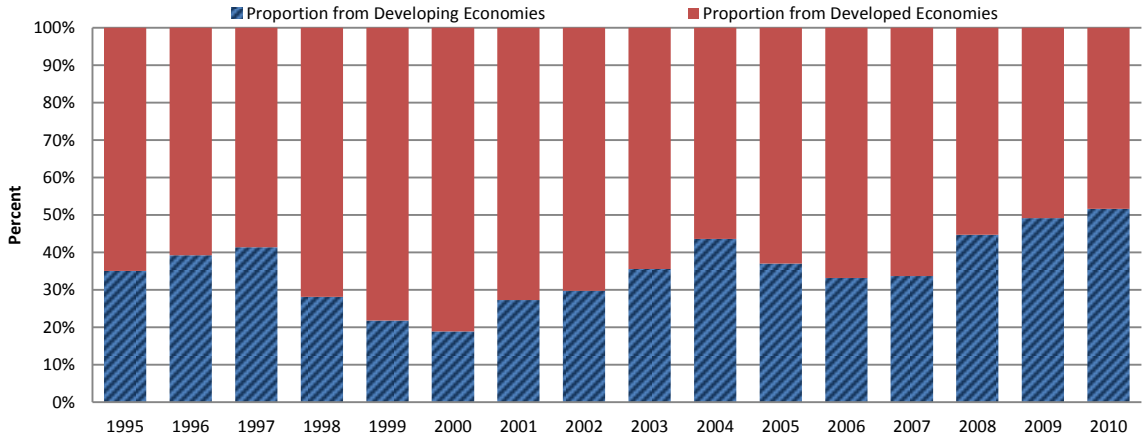


Source: BOP, IMF

Traditionally, global FDI has mostly flowed between developed countries—for example, the United States investing in Western Europe and vice versa; in 2010, for the first time recent history, more than half (51.6 percent) of the world's total FDI inflows were received by developing countries (Figure 2). This reflects more integrated and diversified markets as well as the gradual shift of the global economy's center of gravity toward developing countries. A similar but less pronounced trend has occurred in FDI outflows. In 2000, developed countries were the largest source of outward FDI, with 90 percent of the total, but their share has fallen to 70 percent (Figure 3). This also reflects greater

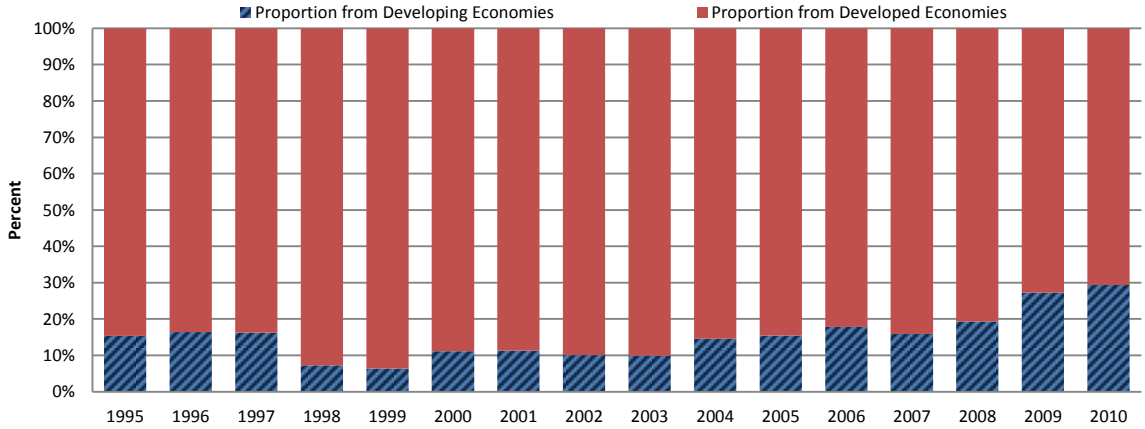
globalization of capital markets and the growing prominence of developing economies in global supply-chain linkages, with their growth-enhancing spillover effects (Box 2).

Figure 2: Inward FDI Flows, 1995-2010



Source: UNCTAD statistics and World Bank staff calculations
Note: Developing economies include both developing economies and transitional economics in UNCTAD.

Figure 3: Outward FDI Flows, 1995-2010

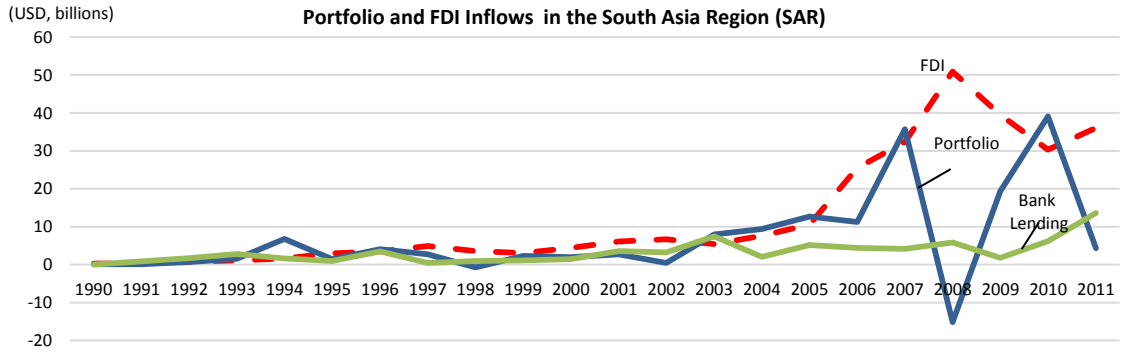


Source: UNCTAD statistics and staff calculations
Note: Developing economies include both developing economies and transitional economics in UNCTAD.

Box 1: FDI and Its Behavior

The IMF's most recent Balance of Payments Manual (BPM6) defines FDI as "a category of cross-border investment associated with a resident in one economy having control or a significant degree of influence on the management of an enterprise that is resident in another economy." This is operationally defined as having at least a 10 percent equity stake in the foreign firm. Inward FDI refers to foreign investment flows into the home countries, whereas outward FDI is the countries' investment flows to other countries. FDI is classified by two types: (1) greenfield investment involves constructing new operational facilities (factories, machinery, etc.) from the ground up and (2) mergers and acquisition (M&A) involve foreign firms acquiring existing assets from local firms. Our analysis in this study will cover both types of FDI together, although the literature has sometimes made a distinction between these two entry modes of FDI in terms of their impact on productivity, growth, and jobs. Some empirical studies suggest that greenfield investment and M&As are not perfect substitutes (Blonigen 1997; Nocke and Yeaple 2007and 2008; and Norbäck and Persson 2008; Bertrand, Hakkala and Norbäck 2012). The choice of entry modes may influence FDI performance and the host country's performance through research and development (R&D), localization of supplies and human resources, and technology transfers. In fact, a group of studies including Calderón, Loayza and Servén (2004), Kim and Zhang (2008), Wang and Wong (2009), Neto, Brandão and Cerqueira (2010) and Harms and Méon (2011) argue that greenfield has bigger welfare impacts on the host countries via increasing capital formation and productivity.

In addition, as a source of capital flows, FDI may exhibit lower volatility than other types of capital flows, such as debt and portfolio equity. The stability of FDI is especially relevant during "sudden stops," or interruptions on capital flows. Capital flows skewed toward non-FDI types, such as bank lending and portfolio investments, may lead to increased vulnerability to economic shocks. This pattern certainly played out in South Asia during the global financial crisis that began in 2008 (see chart below). Regardless of the source of capital flows, significant volatility suggests that there is room for countries to invest in institutions and programs that would help reduce their populations' vulnerability to increased exposure to global (and regional) economic shocks.



Source: BOP, IMF

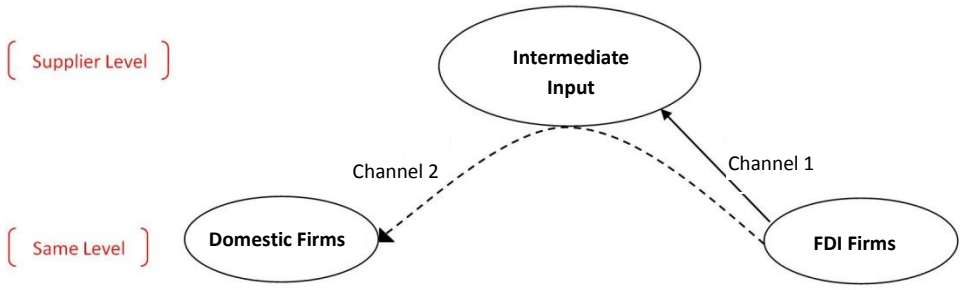
Research has shown that a financial crisis is associated with the exit of investors; however, such crises are equally consistent with an inflow of foreign capital in the form of M&A, dubbed "fire-sale FDI" by (Aguiar and Gopinath 2005). After noting that foreign acquisitions increased by 90 percent in the East Asian crisis 1996-98, Aguiar and Gopinath provide an explanation for FDI's puzzling stability during crises. Firms plagued by liquidity problems are willing to sell their assets at lower prices to foreign investors—hence, the fire sale. India and China were the standout survivors of the financial crisis of 2008-09, invited to the Group of Twenty high table and expected to help steer the course for 21st century commerce. During the financial crisis, we observed large M&A activities flowing from India and China into those countries at the crisis epicenter—an outcome consistent with the theory.

Box 2: FDI's Productivity Spillover Effects in Bangladesh

The garment industry is the largest manufacturing sector in Bangladesh, employing more than 5 million people, or 10 percent of total employment. Eighty percent of the country's exports are textile products. FDI inflows in textiles have increased steadily and reached 30 percent of total FDI in 2011. In the past few years, international brand names in clothing and accessories have made an increasing number of investments as Japan and other countries opted for a "China plus one" trade strategy designed to diversify the risk of excess dependence on any one market.

A study by (Kee 2011) shows that productivity increases can be explained by two FDI channels. The direct effect is the impact of FDI firms on the intermediate input suppliers through its backward connection (channel 1 in the figure below). The investment leads to increases in both the quality of intermediate inputs and the number of suppliers. As the number of FDI firms rises, competitiveness increases, resulting in improvements of the quality and variety of local suppliers and price reductions.

The indirect effect—or shared supplier spillover—is the impact of FDI firms on the domestic firms (channel 2). They receive higher quality intermediate inputs at lower prices as the result of suppliers' more competitive environment. This explains about a quarter of the product scope expansion and a third of the productivity gains within domestic firms.



Since the 2008-09 global financial crises, developing countries' increasing importance has become even more pronounced in global FDI flows—both inward and outward. Stress in global financial markets, risk aversion, and uncertain profits made it more difficult to finance M&A across the globe. In this tough environment, FDI inflows actually contracted more in developed countries than in developing ones. In 2007-09, developed counties' inward FDI flows declined 53.9 percent, while flows to the developing countries fell by only 12.3 percent.[3]

To a large extent, trends in global outward FDI flows mirror inward FDI flows. Outward flows from developed countries experienced a 46.2 percent decline in 2007-10. Outward FDI flows from developing countries also fell over the same period—but by just 8 percent. While FDI outflows have slowly begun to

[3] In this report, developing economies include both developing and transitional economies as defined in UNCTAD.

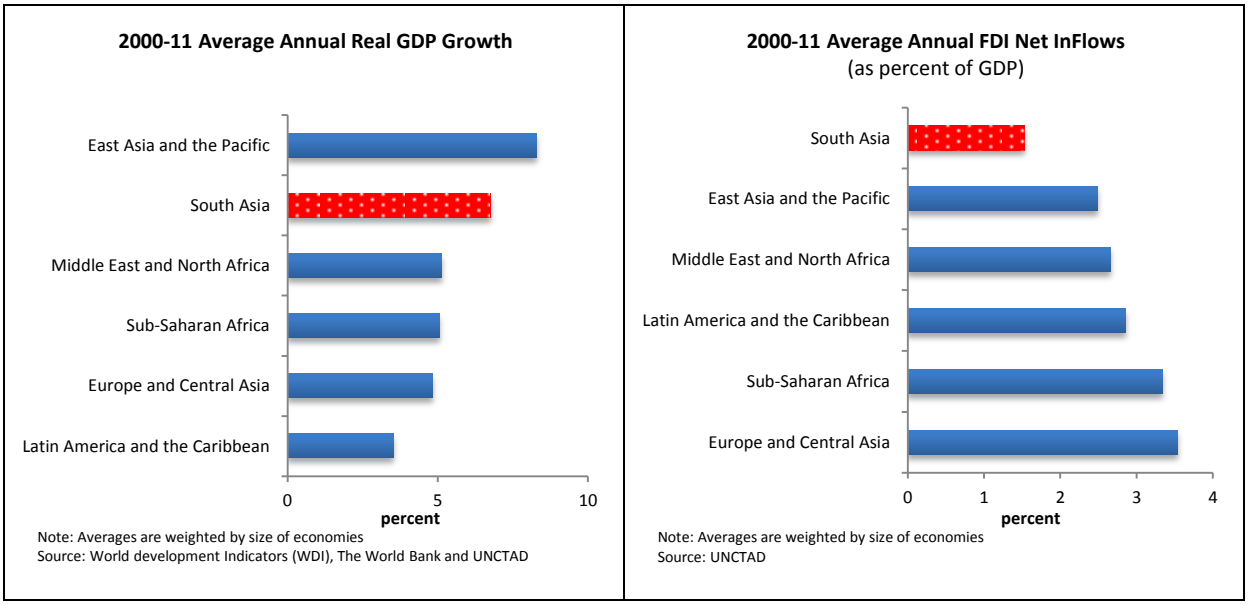
recover globally, they bounced back quite strongly in developing countries and reached 21 percent of total world FDI at the start of 2011.

South Asia and Inward Foreign Direct Investment

South Asia in the Global Context

South Asia's FDI inflows as a share of GDP are among the lowest of all developing regions. South Asia is one of the world's fastest growing regions, averaging 6.7 percent annual increases in real GDP over the past decade (Figure 4, left).[4] After a sustained period of strong growth, the region now stands as the world's third largest measured by GDP. However, South Asia's FDI inflows as a share of GDP are the lowest of all developing regions, averaging less than 2 percent in 2000-11 (Figure 4, right).[5] Although the gap had been narrowing, it regressed somewhat after the global crisis. South Asia's economy is almost twice large as Sub-Saharan Africa's; yet over 2000-11 decade, South Asia's average annual inward FDI flow of US$18.3 billion was smaller than Sub-Saharan Africa's US$19.4 billion.

Figure 4: Average Real GDP Growth and FDI Net Inflows



[4] Regional group definitions are from the World Bank: http://data.worldbank.org/about/country-classifications/country-and-lending-groups.

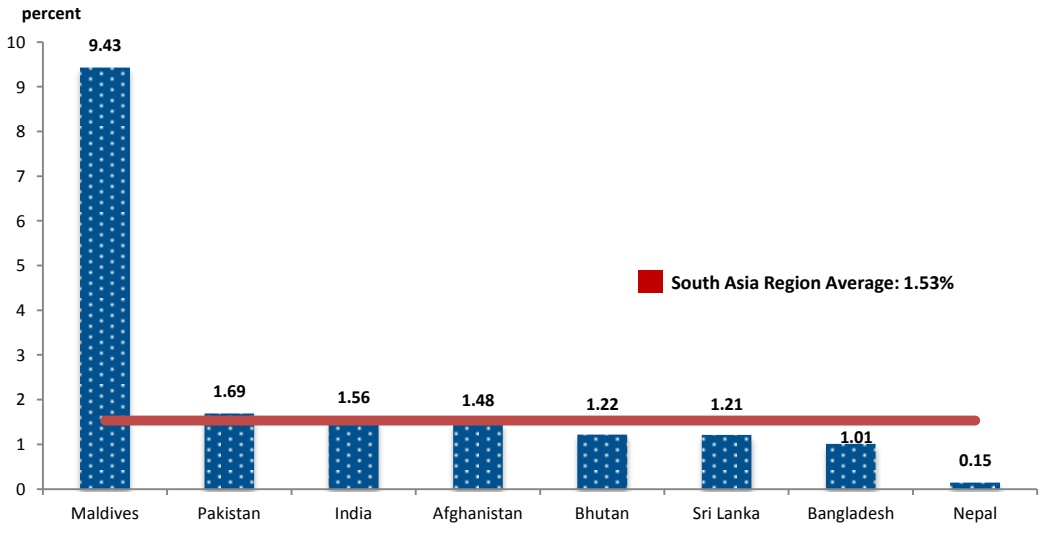
[5] FDI to GDP ratios are frequently used to control for the size of the economies when doing comparisons of FDI.

India represents 80 percent of South Asia's GDP and accounts for about 85 percent of its FDI inflows. Despite the high absolute FDI flows, India's inward FDI relative to the size of its economy is quite low compared to countries of similar economic size. Although India was the second largest developing economy in terms of total Purchasing Power Parity (PPP) GDP, it was the eighth largest FDI recipient among developing countries in 2010, according to the 2011 World Investment Report published by UNCTAD. Among developing countries, by contrast, China is the largest economy in terms of PPP GDP and the largest FDI recipient.

Regional South Asian Trends

Across South Asian countries, FDI inflows vary widely as a share of GDP. The differences reflect geography, levels of development, availability of basic infrastructure, the regulatory frameworks on FDI, and the size of the economies themselves. It may be expected that relatively larger—and perhaps more volatile—FDI inflows would be found in smaller countries simply because domestic investment may be less plentiful, allowing firm-level investment decisions to play a larger role in the overall economy. Indeed, the Maldives has the region's smallest economy but ranks highest in FDI inflows as a share of GDP at almost 5 percent. Afghanistan, Pakistan, and India follow in the ranking. Bangladesh, Bhutan, and Sri Lanka are below the South Asian average (Figure 5). Nepal received the least FDI as a share of GDP.

Figure 5: 2000-11 Average FDI Inflows to South Asia
(as percent of GDP)



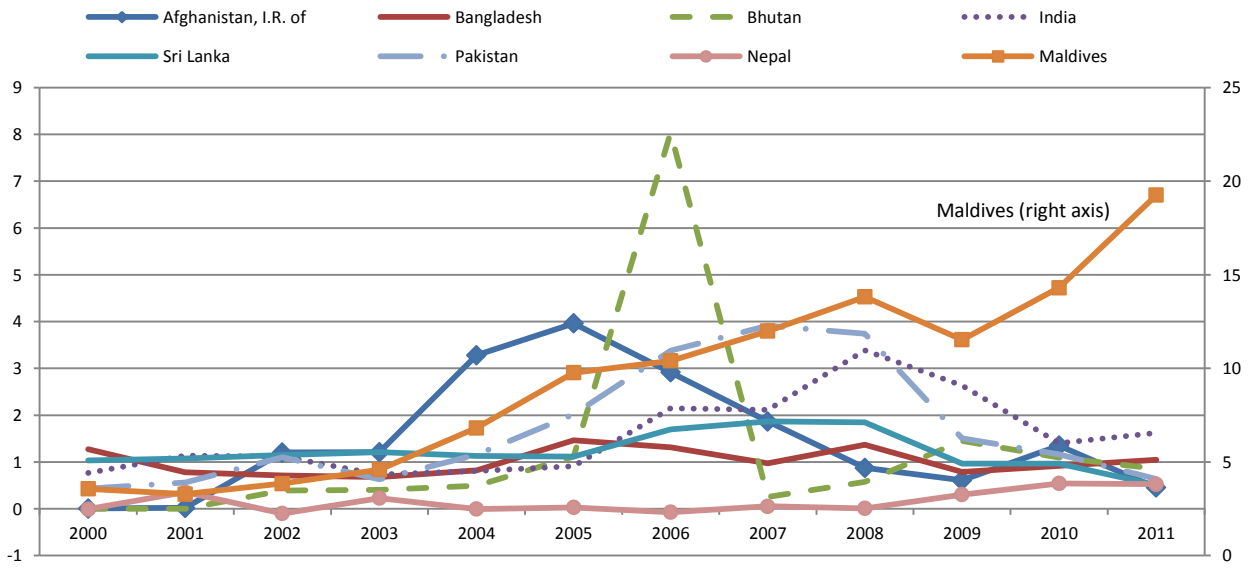
Note: South Asia Region Average is weighted by size of South Asian economies
Source: UNCTAD

FDI inflows, like portfolio capital inflows, move with the global business cycle; during the recent global crisis, FDI dropped in nearly all South Asian countries—some more than others. In relative terms, Pakistan was the most affected by the global crisis. It experienced an 83 percent drop in inward FDI flows as a share of GDP during in 2007-11 (Figure 6). Looking at absolute levels, both India and Pakistan had significant declines in FDI inflows after the crisis in 2008 (Table 1). India experienced a 44 percent slide in FDI between 2008 and 2010. Pakistan was affected even more. Annual FDI to the Pakistani economy fell by 63 percent during the same period and continued to fall in 2011. Foreign investors, particularly from Europe and the United States, suffered higher economic uncertainty, which may have led the decrease in FDI. The fall was compounded by the Pakistan's weakening macroeconomic environment, combined with security issues and political uncertainty. Unlike Pakistan, India's absolute inward FDI flows rebounded in 2011. The country's FDI saw additional but more modest growth in 2012. Later in this report, we will discuss a number of structural and policy reform options available to promote sustainable growth and attract FDI for India and other countries in the region.[6]

Most countries have seen a recovery in FDI flows after the global crisis. In 2009, Maldives FDI was 17 percent less than its 2008 level—but it has since more than recovered and is now higher than before the crisis. In Bangladesh, the financial crisis caused a 20 percent decline in inward FDI, but it rebounded in 2011 signs point further recovery in 2012. Among some countries, FDI tends to be less correlated to the global business cycle, but can be subject to large discrete investments, such as mining projects in Afghanistan. Both Bhutan and Nepal have relatively low FDI levels, and what they receive is linked to large public-sector investments from India. Bhutan's FDI has recently averaged about US$15 million a year since 2009. Nepal's FDI has progressively increased from US$1 million as recently as 2008 to over US$95 million in 2011. Maldives receives the largest share of FDI in GDP, due to the small size of its economy and large inflows of FDI into the tourism sector.

[6] As noted by India's Planning Commission: "To achieve rapid growth, the economy will have to overcome constraints posed by limited energy supplies, increase in water scarcity, shortages in infrastructure, problems of land acquisition for industrial development and infrastructure, and the complex problem of managing the urban transition associated with rapid growth. Greater efforts also need to be made in agriculture, health and education to ensure inclusion of the most excluded and sometimes invisible parts of our population."

Figure 6: South Asia: FDI Inflows
(as percent of GDP)



Source: UNCTAD

Table 1: South Asia Foreign Direct Investment Inflows, 2000-11
(FDI in million USD)

Country	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Afghanistan	0.2	0.7	50.0	57.8	186.9	271.0	238.0	188.7	94.4	75.7	211.3	83.4
Bangladesh	578.6	354.5	335.5	350.3	460.4	845.3	792.5	666.4	1,086.3	700.2	913.3	1,136.4
Bhutan	0.0	0.0	2.1	2.5	3.5	9.1	72.2	3.0	7.2	18.3	16.3	13.9
India	3,588.0	5,477.6	5,629.7	4,321.1	5,777.8	7,621.8	20,327.8	25,505.6	43,406.3	35,595.9	24,159.2	31,554.0
Maldives	22.3	20.5	24.7	31.8	52.9	73.2	95.2	126.5	174.2	152.1	211.8	281.6
Nepal	-0.5	20.9	-6.0	14.8	-0.4	2.5	-6.6	5.9	1.0	38.6	86.7	95.5
Pakistan	309.0	383.0	823.0	534.0	1,118.0	2,201.0	4,273.0	5,590.0	5,438.0	2,338.0	2,022.0	1,327.0
Sri Lanka	173.0	171.8	196.5	228.7	233.0	272.0	480.0	603.4	752.2	404.0	477.6	300.0

Source: UNCTAD

Sectoral Composition of FDI in South Asia

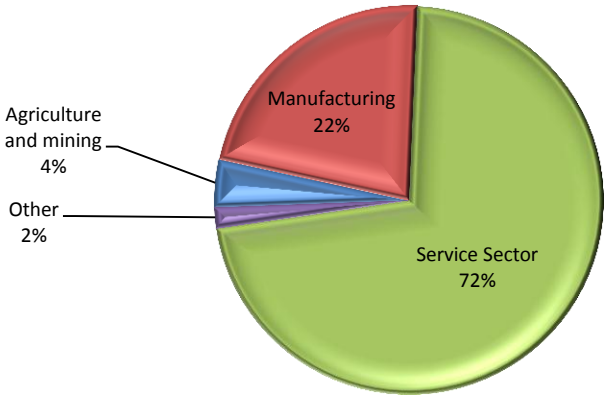
FDI inflows into South Asia are concentrated in the service sector, while investments in manufacturing and agriculture and mining are much smaller (Figure 7).[7] A snapshot of the 2009 statistics shows that the service sector accounted for 72 percent of total inward FDI in South Asia (74

[7] The service sector includes: finance; wholesale and retail trade; business activities; transport, storage and communication; electricity, gas and water; hotels and restaurants; health and social services; education; construction; community, social and personal service activities; public administration and defense; and other services.

percent in India), making South Asia second only to the Europe and Central Asia region (Table 2). South Asia also ranks second among all developing regions in dollar value FDI flows into the service sector—around US$1.9 trillion in 2009. However, South Asia's service sector FDI inflows are not exceptionally high as a share of GDP. This reflects the region's low overall FDI inflows—at 1.77 percent of GDP, the lowest among six regions and well below the developing country average of more than 3 percent (Table 3). As percent of GDP, FDI flows into the South Asian service sector ranked fourth among the six regions in the developing world. While South Asia, especially India, is one of the largest international hubs for the service industry, particularly Business Process Outsourcing (BPO), overall inward FDI flows as a share of GDP compared to the other regions remain modest.

Compared to other regions, South Asia's FDI inflows into manufacturing and agriculture and mining are also modest as a share of GDP. Looking again at the six regions in Table 3, South Asia was next to last in FDI flows into manufacturing and tied for last in agriculture and mining.

Figure 7: South Asia FDI Inflow in 2009: Sectoral Breakdown



Source: International Trade Centre and World Bank Staff Calculations

Table 2: Regional FDI Inflows: Sectoral Breakdown, 2009
(as percent of total FDI)

Regions	Agriculture and mining	Manufacturing	Service	Other
East Asia and Pacific	3.50	45.21	50.81	0.47
Europe and Central Asia	11.43	9.14	77.17	2.25
Latin America and Caribbean	14.42	28.47	52.01	5.11
Middle East and North Africa	38.25	30.50	29.10	2.15
South Asia	**3.95**	**22.28**	**72.04**	**1.73**
Sub-Saharan Africa	57.17	15.78	24.46	2.59

Source: International Trade Centre and World Bank Staff Calculations based on 2009 statistics

Table 3: Regional FDI Inflows: Sectoral Breakdown
(as percent of GDP)

Regions	Total	Agriculture and mining	Manufacturing	Service	Other
East Asia and Pacific	2.13	0.07	0.96	1.08	0.01
Europe and Central Asia	2.26	0.26	0.21	1.74	0.05
Latin America and Caribbean	2.03	0.29	0.58	1.06	0.10
Middle East and North Africa	5.15	1.97	1.57	1.50	0.11
South Asia	**1.77**	**0.07**	**0.39**	**1.27**	**0.03**
Sub-Saharan Africa	4.72	1.51	1.05	1.63	0.00

Source: International Trade Centre and World Bank Staff Calculations based on 2009 statistics

Source Countries for South Asia's FDI Inflows

The number of developing countries investing in South Asia has increased in recent years, which reflects a global trend of more south-south FDI flows. Growth in the number of countries investing in South Asia may suggest greater trade linkages and knowledge spillovers between developing countries and industries, rather than the expansion of investments from a single country with only marginal additional knowledge spillovers. As Table 4 shows, the number of developing countries with FDI positions in South Asia increased from 38 to 45 between the early and late 2000s, while the number of developed countries making investment in South Asia grew by only one (Greece).

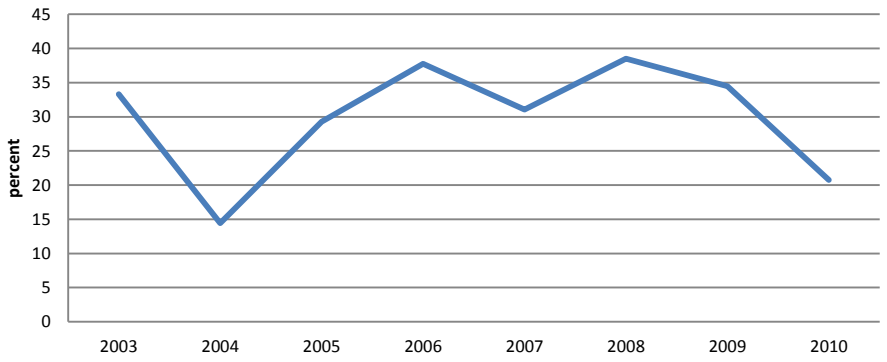
Table 4: FDI into South Asia: Source Country Counts

	Developed Countries	Developing Countries	Total
2003-2006	23	38	61
2007-2010	24	45	69

Source: World Bank Staff estimates from UNCTAD statistics and fDimarkets

Despite the growing number of developing countries investing in South Asia, the developed countries still lead in the value of FDI—and this edge has risen since the 2008 global economic crisis. The value of developing country investments increased for much of the 2000s, hitting a peak of US$603 billion in 2008, or about 35 percent of total inflows. However, the developing countries' share fell back to about 20 percent in 2010 (Figure 8). The global financial crisis' relatively harsher impact on developed economies spurred greater FDI flows into developing countries, including South Asia. Estimates for 2012 suggest that the largest declines in the developing nations' share of South Asia's estimated FDI inflows were from 2009 to 2010.

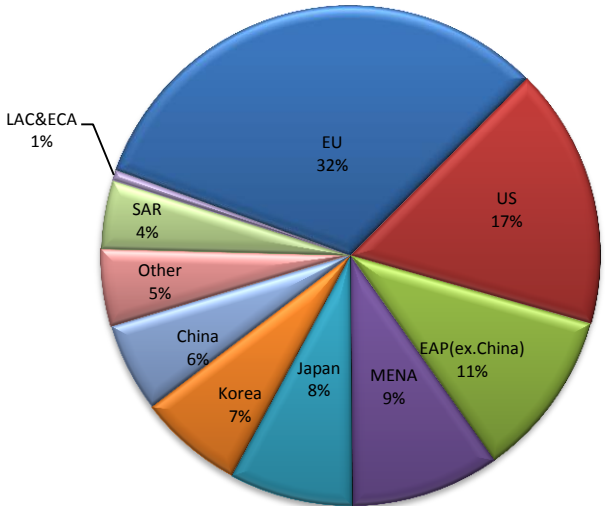
Figure 8: Developing Country Share of Inward FDI into South Asia



Source: UNCTAD statistics, fDiMarkets and World Bank staff calculations

From 2003 to 2011, almost 70 percent of South Asia's inward FDI was from developed countries, including 32 percent from the EU, 17 percent from the United States and 20 percent from other advanced economies. Among developing countries investing in South Asia, the largest shares of inflows arrived from the Middle East and North Africa (MENA) and the East Asia and Pacific Regions (EAP). South Asia itself accounted for 5 percent of FDI within the region (Figure 9). Looking at specific developing countries, the United Arab Emirates contributed 8.5 percent and China (including Hong Kong, Macau, and Taiwan) supplied 6 percent.

Figure 9: Source of South Asian FDI Inflows, 2003-11



Source: Estmates from UNCTAD Statistics and fDimarkets
Note: China includes Hong Kong, Macau and Taiwan

India contributes 70 percent of intra-regional South Asian FDI; however, total within-region FDI represents just 3.7 percent of all inward FDI in South Asia. The largest sources of inward FDI vary substantially across South Asian countries, but historical bilateral restrictions on FDI inflows from other

South Asian countries have limited intra-regional flows. As shown in Table 5, FDI flows to India come primarily from developed economies, such as the EU, United States, Japan, and South Korea. In contrast, Pakistan's inflows are dominated by capital from the Middle East, while Bangladesh's and Sri Lanka's FDI comes from a handful of countries, including the EU, United States, India, and China. The Maldives has perhaps the most diverse spectrum of countries contributing FDI, including Thailand, India, United States, the EU, and China. Landlocked Bhutan and Nepal depend heavily on India for investment in their countries. Chinese companies have made large investments in extraction businesses, which account for a large portion of the FDI in Afghanistan. China has also been active in Nepal's renewable energy sector and in Sri Lanka's transportation sector, specifically building ports, but also in constructing hotels and investing in Sri Lanka's tourism sector.

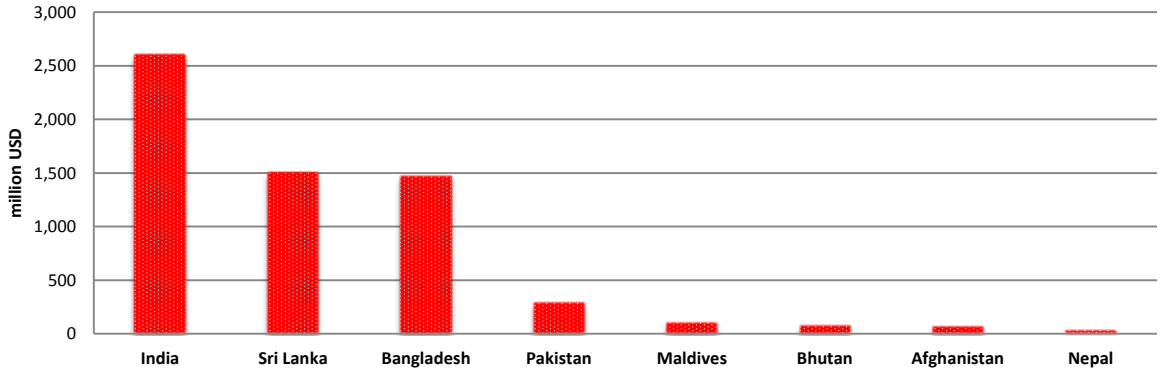
Table 5: FDI Recipient and Source Countries in South Asia
(percent of recipient countries' total FDI inflow, 2003-11)

		Source Countries										
		Europen Union	US	India	SAR,ex India	China*	EAP,ex China	MENA	ECA	LAC	SSA	Other**
Recipient Countries	Afghanistan	2.35%	1.57%	2.72%	0.97%	71.58%	0.00%	16.07%	4.73%	0.00%	0.00%	0.00%
	Bangladesh	38.33%	11.95%	23.88%	0.49%	3.79%	10.02%	8.62%	0.00%	0.00%	0.40%	2.52%
	Bhutan	0.00%	16.91%	48.75%	0.00%	0.00%	24.67%	0.00%	0.00%	0.00%	0.00%	9.67%
	India	36.40%	19.87%	0.00%	1.34%	4.10%	21.26%	5.09%	1.77%	0.56%	0.31%	9.31%
	Maldives	4.71%	3.86%	29.35%	0.05%	3.86%	25.57%	13.13%	0.00%	0.01%	0.00%	19.47%
	Nepal	22.05%	0.00%	53.63%	0.61%	11.20%	1.72%	10.68%	0.00%	0.00%	0.00%	0.12%
	Pakistan	19.60%	9.92%	0.83%	0.30%	6.11%	7.15%	45.04%	1.52%	0.47%	0.00%	9.06%
	Sri Lanka	18.09%	2.95%	37.41%	0.22%	9.19%	8.10%	2.71%	0.00%	0.15%	8.36%	12.82%

Source: Estimates from UNCTAD statistics, fDiMarkets and World Bank staff calculations
Note: (*) China includes Hong Kong, Macau and Taiwan; (**) Other includes all advanced economies other than US and European Union.

India, Sri Lanka, and Bangladesh dominate South Asia's intra-regional FDI (Figure 10). Bangladesh has become a major beneficiary of India's investment in the manufacturing sector (Table 6). Over the past decade, India has made a series of investments in Bangladeshi chemical manufacturing, building and construction materials, industrial machinery, and consumer products. More recently, big Indian manufacturers such as Arvind Mills and Tata Group have invested in the garment industry, one of Bangladesh's most competitive industries. In the services sector, regional banks have set up business in Bangladesh. Apollo Hospitals, India's prominent health-care provider, recently opened its first hospital in Dhaka. Moreover, the country also attracted investments from the region to address the issue of its energy deficits. Investment is also flowing in the opposite direction—from Bangladesh to India. The Pran Group, Bangladesh's largest food and nutrition company, made significant investments in food-processing plants in several Indian states. Greater cross-border investments have helped bring enhanced cooperation between India and Bangladesh (such as infrastructure investments to facilitate trade), and they have leveraged greater FDI from outside the region (Box 3).

Figure 10: South Asian FDI Recipients from Other South Asian Countries, 2003-11



Source: Estimates from UNCTAD statistics, fDiMarkets and World Bank staff calculations

Box 3: Case Study

Lafarge Surma Cement: At the Forefront of Bangladesh-Indian Economic Cooperation

Lafarge Surma Cement Ltd. (LSC) is a private company established in Bangladesh, with registered office in Dhaka. Its main shareholders are the world-renowned multinationals—Lafarge Cement of France and Cementos Molins of Spain.

Bangladesh suffers from a shortage of commercially viable limestone deposits. The raw material is available across the border in Northern India. In November 2000, the governments of India and Bangladesh signed a historic agreement to resolve this issue by permitting an unusual cross-border commercial undertaking. The agreement allows the building and operation of a 17-kilometer conveyor belt from the mine in Meghalaya (India) to the production facility in Chhatak (Bangladesh). According to the company, after three years of production, the Chhatak plant was meeting about 8 percent of Bangladeshi needs for cement and 10 percent of the country's needs for clinker, an input in cement-making.

The total investment of around US$280 million relied on strong support from international finance institutions, including the International Finance Corporation (IFC/The World Bank Group), the Asian Development Bank (ADB), German Development Bank (DEG), European Investment Bank (EIB), and the Netherlands Development Finance Company (FMO).

Source: IFC

Intra-regional FDI coming into Sri Lanka is diversified among a range of businesses, but since the end of the civil war in 2009, priority has been given to improving the services sector (Table 6). Sri Lanka is similar to Bangladesh in the amount of incoming South Asian FDI, although the mix of industries is quite different. During the 26-year conflict, investment in Sri Lanka went mostly into beverage manufacturing, rubber, textiles, and steel. In keeping with the government's development strategy—the Mahinda Chintana—post-conflict foreign investments have been encouraged in the services sector, including business services, retail, health, banks, and consulting. In addition, India's National

Thermal Power Corporation Ltd. (NTPC) and India Oil Corporation (IOC) have ventured into Sri Lanka's energy business. MAS Holdings and Brandix Lanka, Sri Lanka's top apparel firms, have set up large-scale apparel manufacturing parks in India and provide employment for more than 30,000 workers.

India has a large presence in Bhutan and Nepal, particularly in the energy sector. Ongoing cooperation between India and Bhutan in the hydropower sector is covered under the 2006 agreement on cooperation in Hydropower between the two countries and a protocol to the agreement signed in 2009. Under the protocol, Government of India has agreed to develop 10,000 MWs of hydropower in Bhutan for export of surplus power to India by 2020. In Nepal, the largest proportion of FDI goes into the manufacturing, mining and extraction, and power. Notable examples include the GMR Group's investments in Nepal's power sector and Kamdhenu Ispat Steel investments in the country's steel industry. In absolute terms, however, Nepal receives the least intra-regional investment.

Pakistan's and Bangladesh's manufacturing sectors receive a large share of intra-regional financial flows. Despite restrictions, Tata Motors and Bajaj Auto (both Indian companies) have invested in Pakistan's auto industry, and India has invested in as well as the financial sector. Bangladesh has also received large investments from India, but also from Sri Lanka in the garment industry, rubber, chemicals, and other industries.

India has received significant investments in construction and real estate as well as manufacturing. Nearly all countries in South Asia have made investments in India. Notable investments include Sri Lanka's MAS Holdings into India's construction and real estate sector, as well as Brandix Lanka into textile manufacturing; Bangladesh's Pran Group into India's food sector; Nepal's CG Food into the food sector; and Pakistan's DN Impex into food and tobacco sector.

Table 6: Intra-regional Greenfield FDI Inflows by Recipient Country and Sector, 2003-11
(percent of recipient country's total intra-regional FDI)

	Bangladesh	Bhutan*	India	Maldives	Nepal	Pakistan	Sri Lanka
Manufacturing	40.4%	1.1%	16.7%	1.4%	23.9%	77.4%	19.3%
Food and tobacco	1.6%	0.0%	1.8%	0.0%	0.6%	4.8%	1.1%
Mining and extraction	0.0%	0.0%	0.0%	0.0%	22.5%	0.0%	0.0%
Business, Financial, IT and Health Services	12.8%	7.8%	3.1%	5.3%	9.3%	17.9%	16.3%
Hotels, Tourism and Entertainment	1.3%	0.0%	0.0%	13.1%	0.0%	0.0%	7.5%
Construction and Real Estate	4.1%	0.0%	71.5%	80.1%	0.0%	0.0%	23.4%
Communications	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	5.6%
Transportation	0.0%	0.0%	6.4%	0.0%	12.0%	0.0%	6.1%
Energy	39.8%	91.1%	0.5%	0.0%	31.7%	0.0%	20.7%

Source: Estimates from UNCTAD statistics and fDiMarkets. Note: *Investment in Bhutan's hydropower are calculated as 102 billion Rs to be phased out by 2020.

To summarize South Asia's intra-regional FDI flows, much of the investment inflows are concentrated in manufacturing, services (business, financial IT, health, construction, and real estate) and energy. To a large extent, this reflects investments by specific industries in the region that have a comparative advantage in a sector (mostly from India), or where complementariness between countries exists (such as energy trade). Interestingly, the flows also largely coincide with extra-regional FDI (Table 7), with some notable exceptions. First, in Bhutan, unlike intra-South Asian FDI flows that are focused on the energy sector, the country receives a substantial portion of its extra-regional FDI in manufacturing, food and tobacco. Second, Maldives' extra-regional FDI is quite heavily concentrated in hotels and tourism, reflecting foreign expertize in this sector and the fact that tourist arrivals are largely from outside the region, so foreign brand recognition is important. Finally, Pakistan and Sri Lanka, which depend less on Indian FDI—due to formal restrictions and trade and investment, have a wider mix of FDI from outside the region into sectors that differ from the intra-regional investments, such as transport and energy. For a more in depth look at South Asia's trends and developments in FDI inflows see Annex III.

Table 7: External Greenfield FDI Inflows by Recipient Country and Sector, 2003-11
(percent of recipient country's total external FDI)

	Bangladesh	Bhutan*	India	Maldives	Nepal	Pakistan	Sri Lanka
Manufacturing	23.0%	48.1%	29.1%	0.0%	0.6%	16.8%	24.0%
Food and tobacco	3.1%	51.9%	1.4%	0.0%	0.0%	2.1%	4.2%
Mining and extraction	0.0%	0.0%	21.5%	0.0%	0.0%	2.4%	0.0%
Business, Financial, IT and Health Services	10.8%	0.0%	11.6%	3.3%	5.8%	4.4%	16.8%
Hotels, Tourism and Entertainment	0.0%	0.0%	2.3%	71.2%	0.5%	1.7%	23.5%
Construction and Real Estate	3.7%	0.0%	8.4%	19.8%	2.4%	31.7%	0.2%
Communications	11.8%	0.0%	5.5%	0.0%	37.8%	8.6%	5.6%
Transportation	13.0%	0.0%	10.2%	5.8%	20.7%	4.3%	18.9%
Energy	34.5%	0.0%	10.0%	0.0%	32.2%	28.1%	6.9%

Source: Estimates from UNCTAD statistics and fDiMarkets.

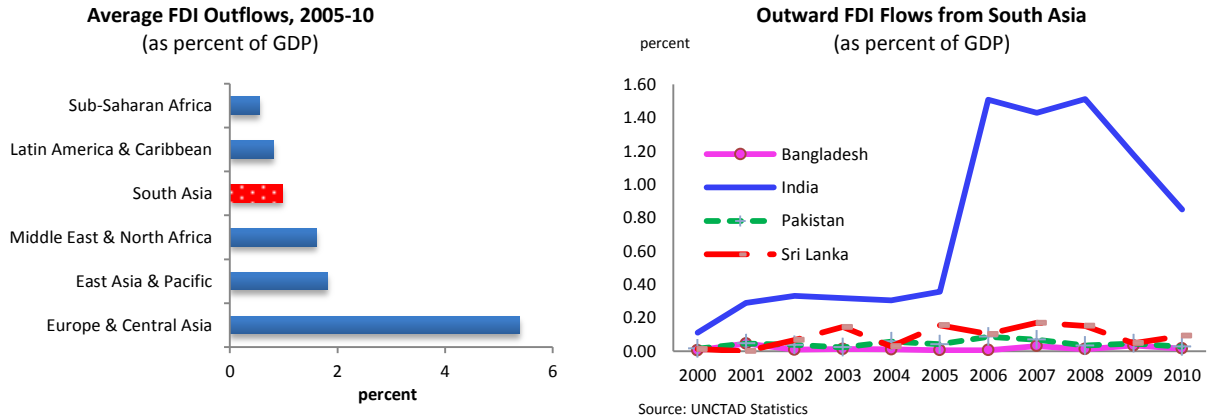
South Asian Outward FDI Flows

South Asian firms, particularly in India, have increased their strategic outward investments. Improving ownership-specific advantages and increased financial capabilities have also played important roles in the strategic shift. Outward FDI flows from South Asia to the rest of the world took off in 2000, almost entirely because of India's more open stance toward outbound FDI. India's outward FDI more than doubled in 2001 to US$1.4 billion and then jumped again to US$14.2 billion in 2006. Although Indian firms had been investing overseas for decades, marked jumps in outward FDI occurred in the 1990s after market liberalization and again in early the 2000s after liberalization of foreign exchange transactions and gradual reductions in the limits on how much firms could invest abroad. In 2000, the Indian government implemented the Foreign Exchange Management Act (FEMA) to facilitate external trade and payments, providing a sound framework for cross-border investments.[8] In addition, the Guidelines for Indian Joint Ventures and Wholly Owned Subsidiaries Abroad, as amended in October 1992, May 1999, and July 2002, provided for automatic approval of outward FDI proposals up to certain limits. The government raised the limit progressively from US$2 million in 1992 to US$100 million in July 2002. In January 2004, the limit was removed altogether, and Indian enterprises are now permitted to invest up to 100 percent of their net worth abroad on an automatic basis (Kumar, 2008). Like other large developing countries over the same period, India has seen an increase in outward FDI flows.

South Asia's outward FDI in 2005-10 totaled US$85.2 billion, surpassing the Latin America and Caribbean region to become the fourth largest FDI investor among developing regions. The bountiful outward FDI shows South Asia's increasing competitiveness and integration with the global economy. Motivating South Asian companies to invest abroad are greater access to global markets, distribution networks, foreign technologies, and strategic assets like natural resources and brand names. A series of liberalization measures have paved the way for more the cross-border investment by South Asian business. Today, South Asia is the fourth largest region for FDI outflows (Figure 11). After India, the largest flows of outward FDI from the South Asia are from Bangladesh, Pakistan, and Sri Lanka. The other South Asian countries, however, show little outward investment (Table 8).

[8] The Foreign Exchange Management Act (1999), or FEMA, was introduced to replace the Foreign Exchange Regulation Act (FERA). FEMA's main objective was to consolidate and amend the law relating to foreign exchange, with the objective of facilitating external trade and payments. It took effect June, 1, 2000. FEMA was introduced because the FERA didn't fit with post-liberalization policies. In a significant change, FEMA made all offenses regarding foreign exchange civil offenses, ending the criminal penalties dictated by FERA.

Figure 11: Average Regional and SAR Net Outward FDI Flows



Source: World Development Indicators and World Bank staff calculations

Source: UNCTAD Statistics
Note: The time series for Afghanistan, Bhutan, Maldives, and Nepal have zero value.

Table 8: Outward Foreign Direct Investment Flows from South Asia, 2000-10
(FDI in million USD)

Country	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Afghanistan	0	0	0	0	0	0	0	0	0	0	0
Bangladesh	2	20.6	4.1	6.2	5.7	3.3	3.6	21	9.3	29.3	15.4
Bhutan	0	0	0	0	0	0	0	0	0	0	0
India	514	1,397	1,678	1,876	2,175	2,985	14,285	17,234	19,397	15,929	14,626
Maldives	0	0	0	0	0	0	0	0	0	0	0
Nepal	0	0	0	0	0	0	0	0	0	0	0
Pakistan	11	31	28	19	56	45	109	98	49	71	46
Sri Lanka	2	0.001	11.5	27.3	6	38	29	55	61.7	20	45.7

Source: UNCTAD statistics

Some of the possible drivers for outward FDI include (Rajan 2009):

- *Market access:* By undertaking overseas acquisitions, firms gain entry into the regulated markets of developed countries. The best example is the Indian pharmaceutical industry, where firms with US FDA-approved facilities are looking for acquisitions in regulated foreign markets to ease the registration processes. The manufacturing activities will still be in India, taking advantage of lower costs.
- *Transfer of technology:* Manufacturing certain products requires technology that is not available to local companies. By acquiring companies abroad, they get access to advanced manufacturing technologies that further help reduce production costs.
- *New product mix:* Companies are also going abroad to broaden their product mixes or acquire products that will otherwise require huge investments and a long time to manufacture indigenously.

- *Presence in a location:* Certain industries spread around the globe through subsidiaries to cater to the tastes and preferences in a particular region. The acquisitions made by these companies are primarily for added value in their product profile.
- *Securing access to raw material:* The rapid growth of many large developing countries—in particular, China and India—is causing concerns about the availability of, and access to, key resources and inputs for continuing economic expansion. Investing abroad will help ensure inputs' availability and cost.

For a more in depth look at South Asia's trends and developments in FDI inflows see Annex IV.

FDI policy enhancements and remaining restrictions in South Asia

The South Asia region is becoming increasingly attractive to FDI, but liberalization of FDI policies is essential to attracting further inflows. Overall, positive changes have taken place over the past few decades. The more advanced economies tend to move more quickly toward FDI liberalization and have more FDI-friendly policies. Nonetheless, investment in South Asia faces significant barriers. The region has lagged in developing policies that directly promote FDI, although it has pursued a number of trade-promoting agreements, which research shows have a positive impact on FDI.[9] However, most of the agreements only reduce tariffs (Box 4). South Asian countries' participation in Bilateral Investment Treaties (BITs) and Double Tax Avoidance Treaties (DTTs) is low (Aggarwal 2008). Below we describe some of the key policy developments and remaining restrictions in South Asia.

FDI policy evolution in India, the largest economy in the region, has gone through three broad phases. From 1948 to 1990, the first phase was characterized by restrictive FDI policy. During the first 20 years, foreign investment received limited concessions, then the Foreign Exchange Regulation Act (FERA), enacted in 1973, restricted foreign equity to 40 percent (with 74 percent for selected sectors). A selective licensing regime further restricted FDI. From 1991 and 2000, the second phase was marked by the famous Indian economic reform, which included liberalization of FDI policy. In 1992, the country introduced the automatic route, which did not require Reserve Bank of India (RBI) approval as long as the investment met certain conditions and stayed below specific ownership caps. By 1996, a cap on inward FDI ranging from 50 percent to 100 percent covered 111 industries, depending on how the investment was categorized. For outward FDI, a fast-track route was adopted in 1995 for amounts up to US$4 million, with cash remittance allowed for up to US$500,000. From 2000 to the present, the third phase saw further liberalization of the FDI policy with the introduction of the Foreign Exchange Management Act (FEMA). Except for a negative list, all remaining activities were placed under the automatic route. The caps that remained in a few industries were further increased, and a number of limits were removed.[10] For Indian companies investing abroad, the annual amount for automatic approval has been raised to US$100 million, and companies are now allowed to invest up to 400 percent of net worth. To facilitate

[9] In 2006, the Agreement on South Asian Free Trade Area (SAFTA) was launched to reduce trade barriers within the region, although much remains to be implemented. In addition, three bilateral free-trade agreements have been signed: India-Bhutan, India-Sri Lanka, and Pakistan-Sri Lanka. Other trade agreements that incorporate South Asian countries include the Asia-Pacific Trade Agreement (India, Bangladesh, Sri Lanka, Philippines, Lao PDR, and Korea) as well as the Bay of Bengal Initiative for Multi-sectoral Technical and Economic Cooperation (BIMSTEC), which involves Bangladesh, Bhutan, India, Myanmar, Nepal, Sri Lanka, and Thailand, aims to achieve its own free trade area by 2017.

[10] For instance, the dividend-balancing condition and limits on payment of royalty were removed.

large amounts of outward FDI, Indian commercial banks are permitted to finance Indian company's outward investments, with a prudential credit limit of 20 percent of the foreign investment.

The progress of India's FDI-promoting policies has accelerated over the past few years. In 2010, India introduced a Consolidated FDI Policy circular, an effort to make FDI more transparent, predictable, simpler, and clearer by combining all policies/regulations in one document. The next year, India established a new consolidated policy to facilitate expansion of foreign-owned enterprises in India. The Indian government formally eliminated restriction on foreign investments in its single-brand retail sector in January 2012.[11] The multi-brand retail sector was also liberalized in 2012, but investment remains subject to approval by individual states. So far, India has signed 80 Bilateral Investment Treaties (UNCTAD 2011) with other countries, which promote FDI flows with the rest of the world. India has entered into Double Taxation Avoidance Agreement (DTAA) with 82 countries, so foreign investors' taxes could be waived. In addition, tax holidays apply in Special Economic Zones, and infrastructure projects enjoy tax breaks.

Despite considerable improvement of FDI policies, Indian regulatory restrictions constrain further FDI inflows from other South Asian countries. The Foreign Exchange Management Act (FEMA) has a number of provisions that restricts investment from South Asian countries. First, investment from Pakistan was banned until recently,[12] and investment from Bangladesh requires special approval from the Reserve Bank of India. Second, FEMA prevents foreign companies from a few countries from establishing branch offices in India. In particular, the regulation targets Iran and China and six South Asian countries—Pakistan, Bangladesh, Sri Lanka, Afghanistan, Nepal, and Bhutan. Companies or citizens from the above list of countries are not allowed to acquire immovable property in India for a branch office, except for Nepal, which can establish liaison offices.

Pakistan has taken measures to liberalize FDI, targeting the infrastructure and services sectors. The country began its FDI liberalization in 1989. The Board of Investment (BOI) was set up to facilitate foreign investments. The New Investment Policy took effect in 1997, aimed at enhancing FDI in targeted sectors, such as infrastructure, software, engineering, and services. Pakistan allows foreign ownership of up to 100 percent for the service sector, infrastructure, and the social sector. In 2011, Pakistan introduced the International Arbitration (International Disputes) Law, a measure to reassure foreign investors about the security of their investments in the country. Attractive tax breaks and duty waivers are available for

[11] However, large single-brand retailing corporations like IKEA still face mandates to source from local Indian SMEs.

[12] On August 1, 2012, the Commerce and Industry Ministry announced that "the Government of India has decided to permit a citizen of Pakistan or an entity incorporated in Pakistan to make investments in India."

foreign investments. While Pakistan's FDI policy environment is among the most liberal in the region, FDI remains constrained due to investor concerns over macroeconomic uncertainty and policy stability (Khalid, et al 2012).

A long history of foreign investment promotion has left Sri Lanka regarded as a country very friendly toward foreign investment. Since the late 1970s, when Sri Lanka launched its economic reform, the predecessor of the current Board of Investment (BOI) has operated alongside the Foreign Investment Advisory Committee to promote investment in export-oriented and high-tech industries. The country's first Investment Promotion Zone (free trade zone), established in 1978, attracted 116 foreign companies by 1985. Sri Lanka's investment policy is based on the 1978 BOI Act, which further encourages investments in a broader list of industries. Under the BOI Act, FDI is permitted in all industries—except for those on a negative list. Sri Lanka provides many tax concessions, including tax breaks on corporate profits, dividends, value-added taxes, and import and excise duties. Sri Lanka also signed double-taxation treaties with a long list of countries.

In May 2010, Bhutan released its new FDI policy, opening its door to foreign investors. All activities not included in a negative list are open to FDI. The new policy allows 100 percent foreign ownership in certain activities, such as education, specialized health services, luxury hotels and resorts, and infrastructure facilities within the services sector.

Bangladesh has embarked on a path toward a more open FDI policy, with attracting power sector FDI its priority. The Foreign Private Investment Act (1980) established the policy framework for FDI. Under this law, FDI is encouraged in all industries (excluding a list of reserved industries), and it is subject to non-discriminatory treatment and protection. To address electricity shortages, the country gives major tax exemptions for power generation. To support export-processing businesses, import duties are exempt for export-oriented industries. Double taxation can be avoided through bilateral tax treaties.

Nepal's FDI policy has not achieved its goals, but further reforms are possible. Nepal's FDI policy is based on the Foreign Investment and Technology Transfer Act 1992, which falls in line with open and liberal economic policies. Under this Act, 100 percent foreign-owned investments are allowed, except for small scale enterprises and a few security-related industries; full repatriation of profits, sales of equity, and dividends and interests are permitted. Nepal established its FDI-promotion agency - the Board of Investment (BOI) - in 2001. A 10-year tax holiday on profits is allowed. Despite its efforts to promote FDI, Nepal trails all other South Asian counties in attracting foreign capital. In recent years, the

government has eyed further reforms to promote FDI. A series of policy changes were proposed in the Ministry of Finance's Budget Speech of 2008-2009, including investment security, legal reform, improvement of investment climate, and laws for development of Special Economic Zones and Export Processing Zones.

In the absence of authorized ways to invest abroad, surveys suggest that other informal channels are increasingly being used, and considerable outbound FDI is taking place, particularly from Nepal. Nepalese companies mostly invest in India, a country that offers market opportunities and is easily accessible across a large, open border. According to anecdotal evidence, regular transfers of money take place outside of formal channels. For larger sums, strategies to circumvent Nepalese capital account restrictions include channeling money through family members living abroad who are partly exempt from restrictions or through understatement of export income.

In addition to informal channels, a few investment projects have been executed after special approval from the national authorities. The Chaudhary Group, a Nepalese company that produces foodstuffs, invested under the name "CG" in Sikkim in 2006, and it is currently investing in Uttarakhand. Chaudhary is considering an expansion of its investment in South India through acquisition of a local company.[13] In Bangladesh, corporations have started to ask their government to loosen its policies and allow for approved outward FDI on case-by-case basis. Among the most prolific supporters has been Bangladesh's PRAN Group, a diversified company with major assets in plastics and agribusiness that had for long planned to expand its business to North East India. These plans were recently approved, but only with special approval from the authorities and under various conditions.[14]

The restricted but ongoing outward FDI from Nepal and Bangladesh are a sign of economic opportunities that remain untapped due to capital-account restrictions. Countries in South Asia will need to carefully weigh these restrictions to determine whether the lost economic opportunities of technology transfer, diversification, and forgone investments are worth the potential benefits of less investment volatility.

[13] Ibid.
[14] Ibid.

Box 4: Progress and Issues Related to South Asian Regional Trade and Investment Agreements

The modest degree of integration through regional trade and investment agreements reflects South Asia's low level of economic cooperation. However, progress may now be in reach, with countries showing a renewed interest in concluding a regional South Asian Association for Regional Cooperation (SAARC) Investment Promotion and Protection Agreement. According to stakeholders, only small technical issues need to be agreed upon by negotiators before the agreement can be concluded. The regional SAARC investment agreement will end negotiations and deliberations that began in 1997, and it is expected to support investment flows across the region.

The trade and investment agreements that South Asian countries have concluded so far offer rather little in terms of regional investment cooperation. Trade liberalization has been pursued through regional and bilateral Free Trade Agreements (FTAs). In addition to the South Asia FTA (SAFTA, 2004), bilateral FTAs link India and Bhutan (2006), India and Nepal (2009), India and Sri Lanka (2001), and Pakistan and Sri Lanka (2005). Four other FTAs are under negotiation—India-Pakistan, India-Bangladesh, Sri Lanka-Maldives, and Pakistan-Bangladesh. These agreements are rather conservative, focusing on reducing or eliminating barriers to trade in goods but not covering comprehensively trade in services, procurement, intellectual property, or investment.

Only a small number of investment promotion and protection treaties—typically referred to as Bilateral Investment Treaties (BITs)—have been reached within the region. Some countries have concluded very few agreements—for example, Nepal has six and Bhutan none. Other countries, such as Bangladesh and Sri Lanka, have entered into more agreements but with only a few partners from the region.

In late 2011, India and Nepal concluded a BIT, which sent a strong signal that increased South Asian regional cooperation on investment matters was within reach. The anticipated SAARC investment agreement will take cooperation a step further, bringing under one treaty the comparably large and diverse SAARC membership. For the most part, the agreement will be modeled on the India-Nepal BIT, featuring treaty language from India's model BIT (the basis for the India-Nepal BIT). The proposed agreement will feature the standard repertoire of legal stipulations usually found in today's BITs, including prohibition of unconfined expropriation, non-discrimination standards, and investor-state dispute settlement (ISDS). These provision all aim to increase foreign investors' comfort level by guaranteeing a minimum standards of treatment.

Once the remaining legal nitty-gritty is negotiated, a SAARC investment agreement will be a strong and encouraging sign that South Asia is aware of the opportunities offered by increased regional cooperation in trade and investment matters. Once in place, the agreement will show that SAARC member countries have the will and strength to establish the legal framework necessary for a more favorable investment landscape.

Determinants of FDI in South Asia

In prior sections, we detailed the general trends and policy constraints on South Asian FDI as well as some of South Asia's experiences with inward and outward FDI. In this section, we look at some of the key determinants of these trends to get insights into how South Asia may promote greater FDI flows. Once the magnitudes and determinants of FDI are known, policy makers can direct their attention to enhancing the factors that are most critical to attracting FDI. Increased FDI can be a powerful complement to leveraging the competitive potential of South Asia, a region highly abundant in labor and natural resources.

What Might Be the Key Determinants of FDI in South Asia?

Research on the determinants of FDI inflows is quite advanced. Several approaches have been taken, including looking at the patterns of FDI over time for a particular country, or a set of countries, as well as cross-country analysis, examining what determines FDI in countries based on certain economic, institutional, geographical, and policy characteristics. Because our main interest is identifying factors that may enhance FDI flows into South Asia, we model FDI growth as a share of GDP as a function of key policy and economic fundamentals—those that have been found to be critical in influencing investors' decision-making as well as those that may be particularly important for South Asia, such as energy availability, the level of trade barriers, and institutional capacity. We use cross-country data for both developing and developed countries from 2000 to 2010.

In the broadest sense, all fundamental economic variables that determine growth and the level of development would also likely determine FDI inflows. Institutions, economic policies, macro stability, and legal and regulatory policies that enhance economic growth and development would also tend to influence FDI flows. Nonetheless, practicality demands being parsimonious in the choice of explanatory variables because many of these factors can be highly correlated, making it observationally difficult to determine the independent impact of all potentially important determinants of FDI growth. For example, measures of institutional development and corruption are likely to be an important determinant of FDI flows, but they are also highly correlated, so distinguishing the independent impacts of both these variables on FDI may be nearly impossible. Moreover, the larger the number of explanatory variables in the analysis, the fewer the degrees of freedom and the number of countries that can be included in the empirical analysis.

We use the following basic cross-country reduced-form model:

$$\dot{FDI}_{2000-2010} = \alpha + \beta_1 FDI_{2000} + \beta_2 NR_{2000} + \beta_3 \dot{F}_{2000-2005} + \beta_4 d_{oil} + \beta_5 d_{region} + \epsilon$$

where FDI represents inward FDI stock relative to GDP, NR represents the stock of natural resources per capita, the superscript (•) denotes the growth rate of the variable over the period shown in the subscript, F represents the vector of explanatory variables that includes proxies for human capital, corporate tax rates, energy availability, financial development, infrastructure, macroeconomic stability, trade barriers, investment policy openness, and control of corruption. The variables d_{oil} and d_{region} are dummies for oil exporter status and regional factors. In sum, the basic model explains the growth of inward FDI as a share of GDP between 2000 to 2010, based on the initial stock of FDI as a share of GDP and the stock of natural resources at the beginning in 2000, the determinates of FDI in the initial years examined (2000-05), and controls for regional and oil exporter fixed effects.

The model used is based on previous formulations found in the literature in terms of the determinates of FDI/GDP.[15] However, unlike prior formulations it considers the long-run *growth* of FDI/GDP (rather than the FDI/GDP levels or short-run movements) and controls for the initial FDI/GDP stock to account for pre-existing conditions that may have determined prior levels of FDI/GDP.[16] This formulation was used for several reasons, including: 1) it provides a method for determining whether FDI/GDP is converging or diverging between countries, based on the coefficient on the initial stock of FDI/GDP, 2) reduces the likelihood of endogeneity and observing spurious correlation, because prior years of changes of the explanatory variables are used, and 3) allows some means for looking at the dynamics of FDI without use of a panel dataset, which increases the number of observations available and allows us to include most of the South Asian region in the data.

A high initial FDI/GDP level may be a conduit for high future FDI/GDP growth, signifying strong institutional qualities, agglomeration effects, and other factors, or it may point to lower future FDI/GDP growth due to diminishing returns on FDI investment in a market that may already be well developed. The past decade suggests the latter effect may dominate because the stock of FDI remains highest in developed countries, but recent growth has been highly concentrated in developing countries. With the highest FDI growth taking place in those countries with relatively small initial levels of FDI, a trend toward convergence in the relative FDI stock may emerge. This is consistent with declining returns to FDI investment as the stock of FDI increases. Unlike other models that attempt to

[15] See, for example, Walsh and Yu (2010), Asiedu (2002), Noorbakhsh, Paloni and Youssef (2001), Mohamed and Sidiropoulos (2010) and Lall, Norman and Featherstone (2003).
[16] We specifically examine long-run trends in FDI inflows to GDP to abstract from short-term cyclical factors.

explain the determinants of FDI, our empirical exercise actually sets quite a high hurdle for finding significant impacts of the explanatory variables. Not only is it restricted to explaining the FDI growth relative to GDP, but it also holds constant the initial level of FDI relative to GDP. Consequently, changes in the factors that may explain FDI/GDP changes will only be important if they add explanatory power above the historical FDI/GDP factors.

To get a sense of causality, and reduce problems of endogeneity, the explanatory variables are derived from the first part of the period, rather than simultaneously with the dependent variable. Indeed, actual FDI flows are likely to be based on decisions made in years prior to the actual measured flows and are based on the expected performance of the economy, so this formulation attempts to match the process of investment decisions.

What Are the Components of the Analysis?

The analysis uses cross-country data from 79 developing and developed countries between 2000 and 2010. All variables, except initial FDI/GDP level and natural resources per capita, are average annual growth rates for 2000-05 and 2000-10 and are calculated as $\dot{x} = \left(\frac{X_T}{X_1}\right)^{\frac{1}{n}} - 1$, where X_T is the observation of the last year, i.e. $T = 2010$ for time period 2000-10 and $T = 2005$ for time period 2000-05, X_1 is the observation for the first year (2000) and n is the time interval, i.e. $n = 6$ for 2000-05 and $n = 11$ for 2000-10. The dependent variable is the growth of inward FDI/GDP from 2000-10, and the independent variables are all growth rates over the first half of the period—with two exceptions. The initial level of inward FDI/GDP is the arithmetic average of the variable over the first half of the period and natural resources per capita is measured in 2000 because it does not change much over the period under study and is a stock variable. A brief description of each of the variables and their expected impact on the growth of inward FDI follows:[17]

Inward FDI Stock as a Share of GDP: As is discussed above, *growth* of FDI stock as a share of GDP is the dependent variable—ultimately, the variable of interest. However, its level at the beginning of the growth period is an explanatory variable and plays an important role in our analysis. It proxies for all the initial conditions the regressors might have on FDI growth, whether it is a low tariff rate at the start of the period, energy availability, or other factors. It may have a positive or negative sign depending on whether the agglomeration effect (greater FDI attracts more FDI) outweighs the convergence effect (diminishing

[17] The summary statistics table is provided in Annex II.

returns to additional FDI).[18] Data on the *inward FDI stock* are from UNCTAD Statistics, Catalogue of Foreign Direct Investment.

Corporate Tax Rates: Higher corporate tax rates are expected to act as a deterrent to FDI by decreasing investment returns. In this study, we use *total tax rate (as a percentage of commercial profits)* available from the World Bank's World Development Indicators (WDI).

Macroeconomic Stability: Researchers (e.g., Bloom, Bond and Van Reenen 2007; Bloom 2009) have found that unstable economic conditions hinder the FDI inflows by increasing uncertainty in forecasts of investment returns, regardless of whether the investment is foreign or domestic. To proxy macroeconomic stability, we use the coefficient of variation for the real exchange rate, controlling for the domestic and US CPIs. We use this simple measure of the bilateral real exchange rate (RER) with respect to the US dollar, rather than an effective RER due to greater data availability. CPI inflation and exchange rates are available from the IMF's International Financial Statistics (IFS).

Human Capital: Higher levels of human capital may have a positive or negative impact on attracting FDI inflows, depending on whether FDI is primarily directed to technology-based industries that depend on skilled labor (Lucas 1990; Zhang and Markusen 1999) or labor-intensive industries attracted to a low-wage labor force (Agarwal 1980).[19] In this study, we use *educational attainment dataset* provided by Barro and Lee on their website.[20]

Quality of Institutions: The role institutions play in all globalization-related issues, including financial globalization, has gained increasing attention in recent decades.[21] Better institutions decrease all types of costs—such as financial, time, and effort costs—related to starting, continuing and even ending a business. They also help create a more business-friendly economic environment by increasing the transparency of rules and regulations and decreasing the information asymmetry in investment-related activities. In this study we use measures of *Control of Corruption* and *Political Stability* data available in the World Bank's Worldwide Governance Indicators (WGI).

Investment Policy Openness: The more open the investment regime, the greater the expected FDI flows. Most countries have restrictions on investment, and, as noted above, these barriers are particularly in

[18] For example, see (Wheeler and Mody 1992), (Barrell and Pain 1999), (Campos and Kinoshita 2003), and (Walsh and Yu 2010).
[19] For example, see (Root and Ahmed 1979), (Schneider and Frey 1985), (Narula 1996), and (Noorbakhsh, Paloni and Youssef 2001).
[20] http://www.barrolee.com/
[21] For example, see (Wheeler and Mody 1992), (Root and Ahmed 1979), (Agarwal 1980), (Wei 2000), (Asiedu 2002), (Dutta and Roy 2008), and (Solomon and Ruiz 2012).

South Asia. Some nations impose different rules for foreign and domestic investment; some restrict access to foreign exchange; some impose limits on payments, transfers, and capital transactions; some close certain industries to foreign investment. The proxy for this variable comes from the Heritage Foundation's *Investment Freedom index* and takes the value of 100 for no restrictions and subtracts points for each restriction found in a country's investment regime.

Infrastructure: The availability and quality of infrastructure is a key determinant of FDI inflows.[22] Better infrastructure facilitates investment, decreases production costs, improves service provision, and increases investment returns. This study relies on the most frequently used data on infrastructure—the *ICT infrastructure* data, which can be found in the World Bank's WDI. Other data utilized for robustness, although not as complete, *quality of logistics and ports* and *roads per capita* are used for robustness. They are available at the same source.

Trade Openness: Free trade should be an important factor for attracting FDI, particularly in export-oriented businesses. In addition to allowing the FDI-related products to be easily exported, more open trade lowers the costs of imported inputs. On the other hand, high tariff barriers may also attract FDI into by providing entry into a protected domestic market with prices higher than what they would be in competitive markets. *Applied tariff rates* are the proxy for trade openness. The data come from UNCTAD Statistics, Catalogue of International Trade under the "Market Access" category. Alternative measures of trade policies are also used, such as the ratio of imports and exports to GDP and the Overall Trade Restrictiveness Index, available from the World Bank's WDI.[23]

Energy Availability: Availability of energy is a key determinant for any kind of investment in the production sector, and its scarcity may be a big deterrent of FDI in developing countries (UNCTAD 1998). [24,25] In this study, we measure energy efficiency by *electric power transmission and distribution losses (percent of output)*, available from the World Bank's WDI.

Natural Resources: Natural resource availability has often been studied as a determinant of FDI.[26] It captures both the incentives for investments to exploit countries' natural resources and the availability of productive inputs. We measure natural resources on a per capita basis to control for population size. The data include oil and natural gas as well as other resources. However, the marginal impact of this variable

[22] For example, see (Addison and Heshmati 2003), (Asiedu 2002), and (Blonigen and Piger 2011).
[23] Please refer to (Gastanaga, Nugent and Pashamova 1998) to learn about different measures of openness.
[24] For example, see (Noorbakhsh, Paloni and Youssef 2001), and (Wilhelms 1998).
[25] Energy-investment relationship is detailed in a global corporate survey by PricewaterhouseCoopers 2012.
[26] For example, see (UNCTAD 1993, 1998), (McKern 1996), (Asiedu 2002), (Mohamed and Sidiropoulos 2010), and (Anyanwu 2012).

is primarily non-oil and natural gas resources because we include a dummy variable to capture the particular structure of oil-exporting economies. The variable is measured in thousands of US dollars per capita and includes the estimated discounted present value of *Crops, Pasture Land, Timber, Non-Timber Forest, Protected Areas, Oil, Natural Gas, Coal, and Minerals resources.* The estimates, produced by the World Bank staff, are available in *The Changing Wealth of Nations* catalogue.

Financial Development: On one hand, financially developed economies ensure the availability of required capital for production and may act as an FDI deterrent. On the other hand, financial deepening can also decrease transaction costs of investment and facilitate all sorts of financing activities, thus playing a key role in attracting FDI (Al Nasser and Gomez 2009). As in other studies, financial development is measured by the private credit to GDP ratio, available from the World Bank's WDI.[27]

Labor Costs: Low labor costs may be associated with greater FDI inflows—if accurately measured in a model that accounts for differences in worker productivity. Labor costs have been included in previous studies examining FDI (e.g. (Eichengreen and Tong 2007). We proxy labor cost using the gross average real monthly wage in local currency, available at the ILOSTAT Database produced by the International Labor Organization (ILO).

Empirical Findings

The table in Annex I shows the regression results, presented for developing countries only (first four columns) and for the world as a whole, including both developing and developed countries (last four columns). Developing countries are those with upper middle income status or below.[28]

Column 1 presents the base model results and the remaining columns show alternative specifications. For the most part, the variables have the expected signs. The initial FDI/GDP share is negative, suggesting conditional convergence. FDI as a share of GDP is growing faster in countries that have FDI lower stocks, but this is significant only in the world sample (column 5). This variable's higher significance in the world sample is probably due to greater FDI flows going from developed to developing countries over the sample period; hence, this factor has more variance in the world sample.

[27] For example, see (Demirgüç-Kunt and Beck 2009) and (Beck, Demirgüç-Kunt and Levine 2000).
[28] World Development Indicators (http://data.worldbank.org/data-catalog/world-development-indicators).

The size of the coefficient suggests that countries with low FDI/GDP are conditionally catching up to countries with higher FDI/GDP at a rate of about 0.06 percentage points per year.[29]

One factor that appears significant as a determinate for FDI/GDP growth is a rate reduction in corporate taxes as share of profits (particularly for the developing country sample). For developing countries, lowering corporate tax rates may have a predominantly positive impact on FDI, especially if taxes are imposed more stringently on foreign-owned enterprises than on domestic ones. A one percent decrease in corporate rates would cause about a half a percentage point increase in FDI/GDP growth.

Another significant factor is increasing trade liberalization. A one percent decrease in tariff rates would cause about a 0.13 percentage point increase in growth in FDI/GDP. While high tariffs may give some companies an incentive to invest in protected markets, greater trade liberalization has a positive overall impact on attracting FDI, perhaps because protectionism distorts relative prices and increases production costs (through higher prices for inputs and imported capital goods and the deterrent to efficient supply-chain creation).

Institutional improvements, particularly in controlling corruption, have a robust positive and significant impact on FDI/GDP for both the developing countries and the world sample. So does investment policy openness. Natural resource endowments have a positive and significant impact on FDI/GDP—but just for the world sample. At least for the period of study from 2000 to 2010, this suggests that the significance of this variable may be influenced by investments going from developed countries to developing ones and not by investments between developing countries themselves.

The dummy variable for large oil-exporting economies is strongly significant and negative. This runs counter to the expectation that oil-rich countries would provide a strong attraction for FDI. However, the equation holds constant initial levels of FDI/GDP that may have been high for these countries. During the period of study, oil exporters may not be attracting additional inflows of FDI because they were high recipients in prior years.

In both the developing country and world samples, efficiency of energy supply and macroeconomic stability do not appear to have a statistically significant impact on the growth of FDI/GDP. The lack of significance on these variables may either be because they are not good proxies for the presumed economic relationships (a country may have a plentiful supply of energy, but nonetheless be subject to large distribution and power losses, for example) or, they may simply not be consistently good indicators

[29] The rate of convergence is calculated as $\lambda = -\ln(1+\hat{\beta})/t$, where t is 1 (since growth is annualized, the period over which growth is calculated is 1) and $\hat{\beta}$ is the estimated coefficient on the level of FDI/GDP in the starting period.

for determining the growth of FDI/GDP. Other factors that were believed *a priori* to be potentially important to determining FDI/GDP growth, such as wage rates, infrastructure, and financial market development, proved to be less robust than expected, with high standard errors and weak significance. Overall, the empirical results explain about 60 percent to 70 percent of the variation in FDI/GDP growth for the developing countries and the world sample, as indicated by the adjusted R-square.[30] The summary statistics of the variables are presented in Annex II.

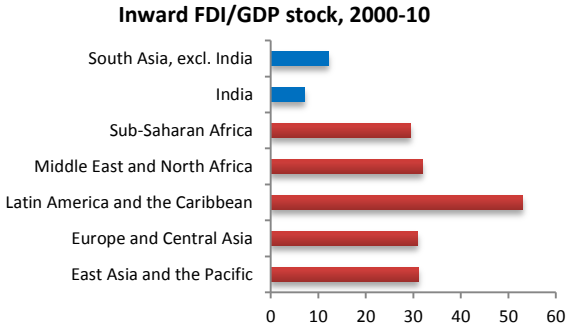
How Does South Asia Rank Among Other Developing Countries?

The series of graphs in Figure 12 compares South Asia and other developing regions on the explanatory variables used in the regression analysis. India and the rest of South Asia stand out generally as having a weak environment for attracting FDI. It had the lowest initial level of inward FDI/GDP. It had the lowest reduction corporate tax rates as a share of profits (and actual increases in South Asia excluding India). It has had the largest decline in investment policy openness, the lowest level of natural resources per capita, and largest deterioration in political stability (particularly for South Asia excluding India).

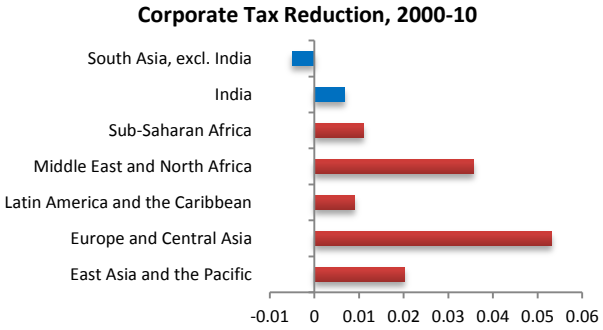
South Asia does well on some indicators. The region's human capital growth has been stronger than other regions, it has the largest reduction in energy losses (despite only weak improvements in India), financial sector development growth is second only to the Europe and Central Asia region, and infrastructure growth has been second only to Sub-Saharan Africa. For India, trade liberalization (as measured by reduced effective rates of tariff protection) and investment policy openness has been particularly strong during this period, while for the rest of South Asia it has shown only modest improvements or deterioration. However, with the exception of overall trade liberalization and investment policy openness in India, these factors are not found to be significant determinants of FDI/GDP in the regression analysis, but they may be important contributors to growth. This may partly explain the region's relatively strong GDP growth over the past decade, despite a period of relatively weak growth in FDI inflows.

[30] The equations were estimated utilizing the Huber-White sandwich estimators, with account for a collection of potential concerns over the violation of the standard assumptions of OLS estimators, such as normality and possible heteroscedasticity. Other potential problems like model specification and nonlinearity of the parameters were tested using the Ramsey Reset test, but were not found to be statistically important issues.

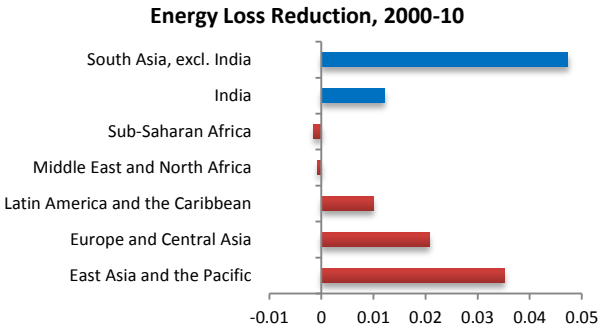
Figure 12: Determinants of FDI/GDP Growth (Regional Groupings), 2000-10



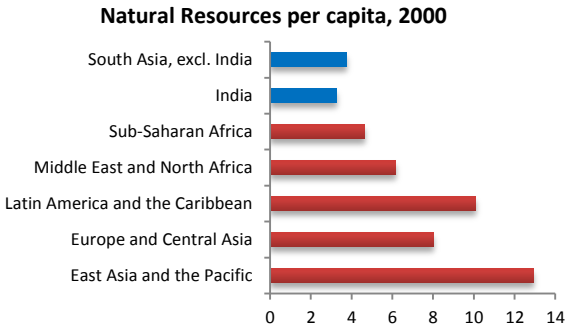
Source data: UNCTAD statistics and World Bank staff calculations



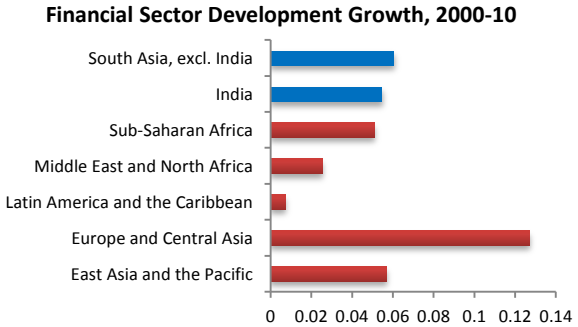
Source Data: WDI and World Bank staff calculations



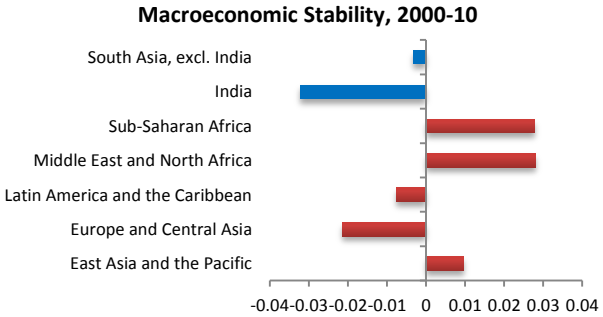
Source Data: WDI and World Bank staff calculations



Source Data: World Bank, Wealth of Nations Catalog

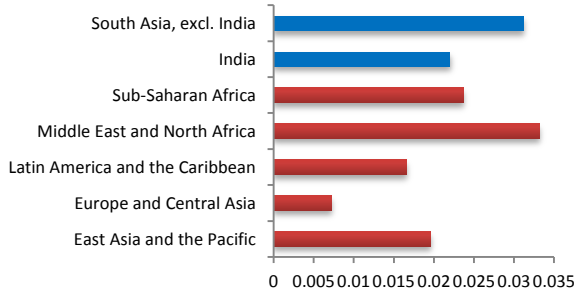


Source Data: WDI and World Bank staff calculations
Note: The variable is defined as Private Sector Credit (% GDP).



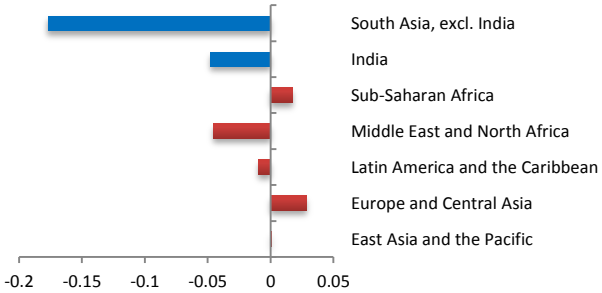
Source Data: IFS and World Bank staff calculations
Note: The variable is defined as real exchange rate variability

Human Capital Growth, 2000-10



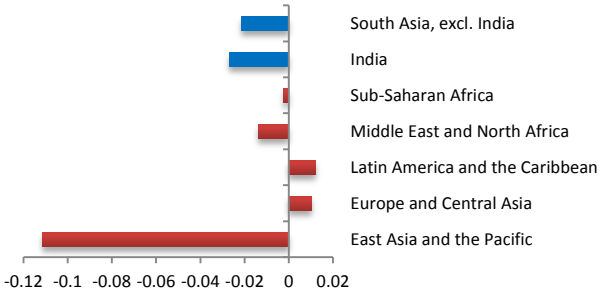
Source Data: Barro & Lee and World Bank staff calculations
Note: The variable is defined as secondary and tertiary schooling

Political Stability Changes, 2000-10



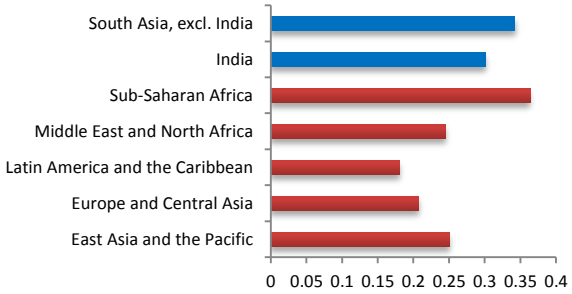
Source Data: Worldwide Governance Indicators , the World Bank

Control of Corruption Changes, 2000-10



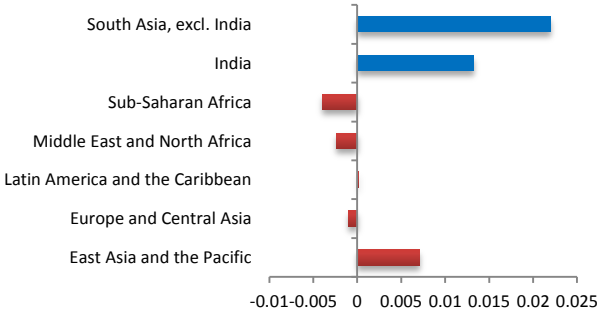
Source Data: Worldwide Governance Indicators , the World Bank

ICT Infrastructure Growth, 2000-10



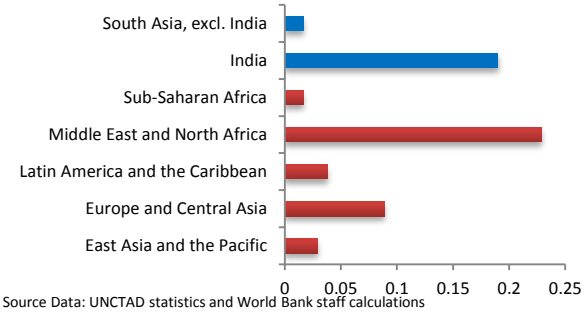
Source Data: WDI and World Bank staff calculations

Road Infrastructure Growth, 2000-10



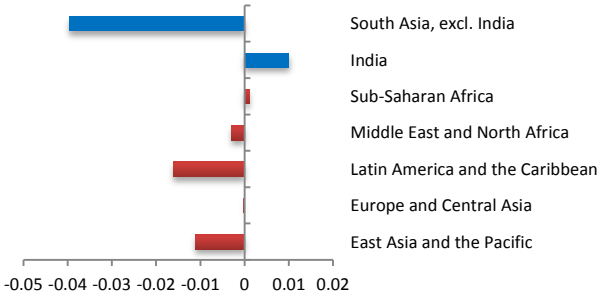
Source Data: WDI and World Bank staff calculations

Trade Liberalization Growth, 2000-10



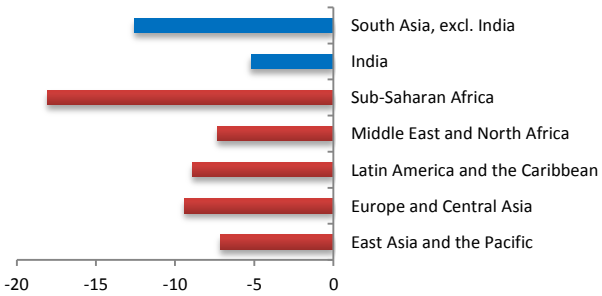
Source Data: UNCTAD statistics and World Bank staff calculations
Note: The variable is defined as effective tariif rate reduction

Investment Policy Openness Growth, 2000-10



Source Data: Heritage Foundation and World Bank staff calculations
Note: The variable is defined as growth in investment freedom index

Real Wage Growth, 2000-10



Source Data: ILO and World Bank staff calculations
Note: The variable is defined as nominal wage divided by CPI

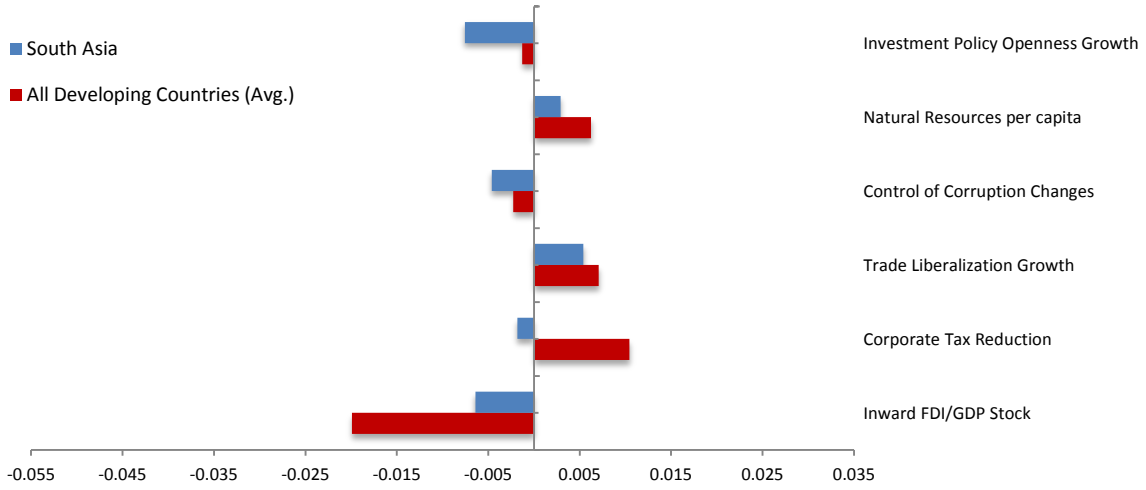
* South Asian countries in Figure 12 do not include Afghanistan due to its lack of data.

Accounting for FDI Growth—Comparing South Asia to Other Developing Regions

Using the base-model regression results for developing countries, and including actual data comparing South Asia countries to all developing countries, we can determine how South Asia's characteristics contributed to FDI/GDP growth relative to all developing countries. Only determinants that add to the explanatory power of FDI/GDP growth model are shown.

Compared to other developing countries, South Asia's is quite modest on factors that contribute to FDI/GDP growth (Figure 13). While all developing countries have slid in investment policy openness and control of corruption, South Asia, as a whole, has seen the largest declines by far, contributing to its slower FDI/GDP growth. While developing countries as a whole have reduced corporate taxes, South Asia stands out a laggard primarily due to increase in Sri Lanka's tax rate. Trade liberalization has been a positive contributor to South Asia's FDI/GDP growth, but the region has done less than other developing countries. On a positive note, South Asia's low initial level of FDI stock suggests greater potential for future FDI growth.

Figure 13: Contribution of SAR Economic Fundamentals to FDI/GDP Growth *
(Dependent Variable: Inward FDI Stock (% GDP) Annual Growth, 2000-10)



* The graph includes only the variables that add to the explanatory power of the model. (estimates with t-values of greater than 1)

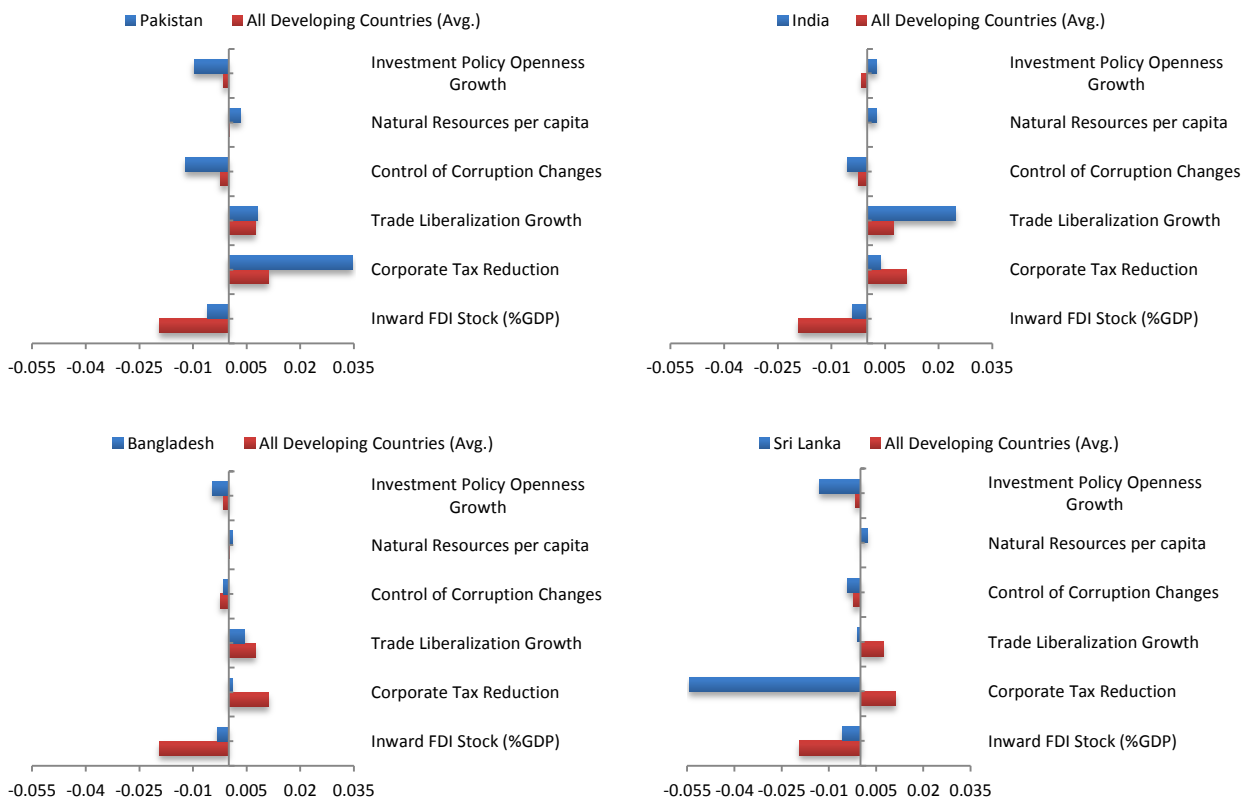
Figure 14, splits South Asia into its constituent countries to show the diverse regional experience, but also commonalities across the region. India, which accounts for some 85 percent of regional FDI inflows, is unique in its strong improvements to investment policy and trade liberalization, which have played a positive role in enhancing growth in FDI/GDP. Its other characteristics that influence foreign direct investment, such as control of corruption and corporate tax changes have been quite similar to the rest of South Asia. For Pakistan, reductions in corporate tax rates have been a large positive factor in enhancing FDI/GDP growth compared to other developing countries and the rest of South Asia, while control of corruption and improvements in investment policy growth have been relatively large detractors.

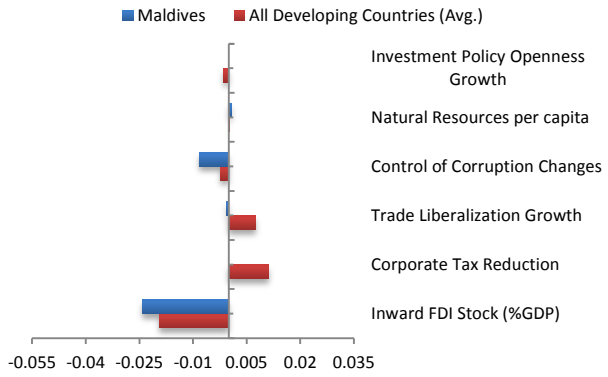
Overall levels of FDI to GDP are relatively small in Bhutan and Nepal, suggesting a large potential for future growth in foreign investment, which are complemented by high natural resource endowments due to the unexploited hydropower potential. Nonetheless, the deterioration in investment policies has been a relatively large deterrent to foreign investment growth in Nepal. For the Maldives, the current large stock of FDI to GDP suggests that potential for future growth in foreign investment is modest.

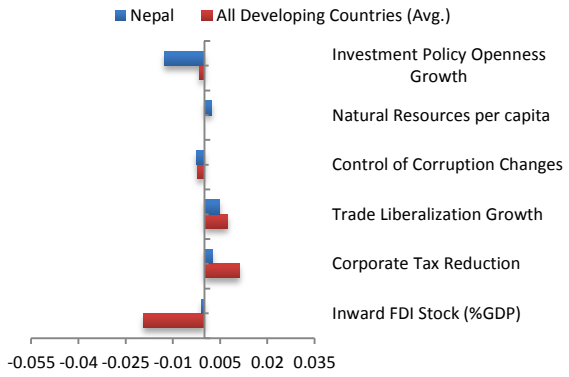
Control of corruption is a significant detractor to the growth in FDI/GDP for most countries in the SAR region, with the exception of Bhutan, where improvements have been a positive contributor to foreign investment. However, Bhutan has raised its level of trade protection, somewhat offsetting the positive impact of the gains through controlling corruption.

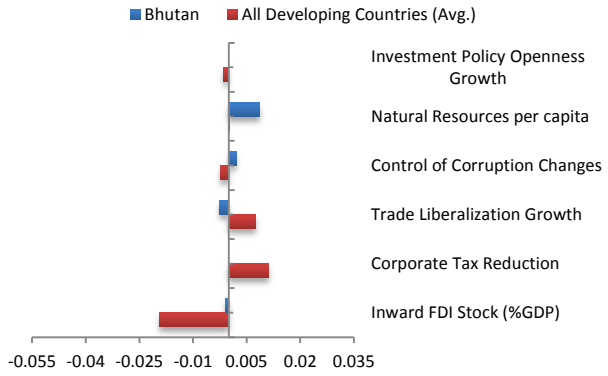
Overall, the results suggest South Asia has the potential, through policy changes, to take important steps to becoming a much greater magnet for foreign investment.

Figure 14: Contribution of Economic Fundamentals to FDI/GDP Growth by South Asian Countries (Dependent Variable: Inward FDI Stock (% GDP) Annual Growth, 2000-10)









* The graphs include only the variables that add to the explanatory power of the model (estimates with t-values of greater than 1).

Conclusions

Globally, inward FDI flows have followed a hump-shaped pattern over the past decade, with strong growth before the global crisis and a sharp drop as many economies struggled in 2008-2011. FDI inflows to developed economies fell significantly in the midst of the crisis, and have yet to fully recover; by contrast, FDI flows to developing economies have begun to recover more rapidly than many forecasters would have predicted. Recent decades have seen a gradual shift of the center of gravity for FDI inflows from developed economies to developing ones. Currently, more than half of the FDI goes to developing countries. Strong growth in the developing countries, overall improvement in their business environments, and more open FDI policies have played a large role in the paradigm shift. Many emerging economies have been actively courting FDI from both advanced and other developing countries. They're doing so to take advantage of supply-chain linkages, technology transfers, and natural resource opportunities. India has been a notable player in this process.

South Asia has seen FDI increases in the past decade and reaped their benefits; however, the region lags the rest of the other developing nations. Weak fundamentals have prevented more FDI flows into South Asia. The composition of FDI is heavily focused on the service industry, which may reflect the

region's comparative advantage in this sector, but also may indicate that FDI into other sectors, such as manufacturing, is low due to insufficient infrastructure and cumbersome regulations discourage FDI inflows to these industries more than into services.

The empirical analysis presented in this study offers a powerful set of factors as key contributors to FDI growth—control of corruption, lower taxes, reduced trade protection, and greater investment openness. South Asian countries have several good options for improving FDI flows into and within the region and doing so could provide a strong foundation for continued growth. Progress has been made on the policy front in many South Asian countries over the past decade, but policy makers need to remain vigilant and keep the reform momentum going forward rather than sliding backwards, particularly in the current context of the South Asia's economic slowdown. Regional growth has slowed from 9.3 percent in 2010 to 5.4 percent in 2012, and some local businesses are advocating quick short-term solutions through protected markets. Concerns have recently been raised by multinational corporations that new policies to protect domestic business are deteriorating the attractiveness of investing in the region, and thus many hurt long-term growth prospects. Initiatives to promote domestic interests, while at first appearing to help strengthen the domestic economy may, in the end, do just the opposite. While foreign direct investment is not the only building block of a strong and growing domestic economy, it complements other components and is oftentimes a bellwether for future growth prospects.

Annex I: Table of Results

	Developing Countries				World			
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Inward FDI/GDP Stock	-0.000559	-0.000600	-0.000271	-0.00130	-0.000530**	-0.000573**	-0.000386	-0.000479
	(1.353)	(1.398)	(0.517)	(1.469)	(2.232)	(2.377)	(1.372)	(1.047)
Human Capital Growth	0.591	0.625	-0.0192	0.766	-0.000103	0.0387	-0.335	-0.245
	(0.901)	(0.832)	(0.0208)	(0.585)	(0.000328)	(0.117)	(1.225)	(0.925)
Corporate Tax Reduction	0.551*	0.565*	0.138	0.762**	0.398*	0.377	0.119	0.413
	(1.983)	(1.770)	(0.697)	(2.394)	(1.786)	(1.496)	(0.664)	(1.637)
Energy Loss Reduction	0.0959	0.128	-0.0206	0.119	0.0186	0.0458	-0.0670	-0.00429
	(0.668)	(0.847)	(0.148)	(0.572)	(0.151)	(0.363)	(0.608)	(0.0282)
Natural capital per capita	0.000796	0.00111	0.00107	0.00132	0.00100***	0.000957***	0.000861***	0.000969***
	(0.587)	(0.645)	(0.846)	(0.685)	(5.208)	(4.995)	(4.070)	(3.630)
Financial Development Growth	0.0175	0.0327	0.0884	0.145	-0.0186	-0.00730	0.0605	0.0145
	(0.116)	(0.210)	(0.532)	(0.721)	(0.216)	(0.0813)	(0.780)	(0.140)
Trade Liberalization Growth	0.130***	0.113**	0.156***	0.0905	0.129***	0.116***	0.150***	0.106***
	(2.910)	(2.376)	(3.925)	(1.623)	(3.702)	(3.062)	(4.628)	(3.000)
Investment Policy Openness Growth	0.254**	0.299**	0.217*	0.137	0.343***	0.396***	0.234***	0.320***
	(2.427)	(2.632)	(1.939)	(0.890)	(4.049)	(4.131)	(2.773)	(3.343)
Macroeconomic Stability	0.00843	0.0238	0.0289	0.0167	-0.0114	0.00376	0.0186	-0.000695
	(0.166)	(0.437)	(0.578)	(0.267)	(0.234)	(0.0753)	(0.405)	(0.0107)
Control of Corruption Changes	0.208**		0.156	0.107	0.208**		0.165*	0.286
	(2.563)		(1.354)	(0.543)	(2.451)		(1.682)	(1.656)
ICT Infrastructure Growth	0.00757	0.0470		-0.0246	0.0872	0.122**		0.0837
	(0.107)	(0.669)		(0.187)	(1.506)	(2.073)		(0.929)
Political Stability Changes		0.0286				0.00227		
		(0.486)				(0.0404)		
Road Infrastructure Growth			0.0900				0.0531	
			(0.316)				(0.241)	
Real Wage Growth				7.55e-07				0.000348
				(0.000332)				(0.232)
Oil dummy	-0.0741***	-0.0779***	-0.0497**	-0.125***	-0.0560***	-0.0534***	-0.0388**	-0.0572**
	(4.020)	(3.325)	(2.099)	(2.983)	(3.564)	(2.860)	(2.215)	(2.086)
EAP	-0.00600	-0.0204	-0.00705	0.00246	0.000279	-0.00901	0.00955	0.00802
	(0.152)	(0.455)	(0.188)	(0.0397)	(0.00940)	(0.277)	(0.314)	(0.215)
ECA	0.0451	0.0330	0.0484	0.0358	0.0398**	0.0363*	0.0524***	0.0405*
	(1.194)	(0.720)	(1.243)	(0.552)	(2.470)	(1.999)	(3.818)	(1.720)
LAC	0.0473	0.0440	0.0386	0.0775	0.0360**	0.0349*	0.0494***	0.0538*
	(1.670)	(1.415)	(1.253)	(1.586)	(2.053)	(1.984)	(2.825)	(1.879)
SA	0.0247	-0.000864	0.0305	0.0659	0.0228	-0.00379	0.0458**	0.0478
	(0.880)	(0.0274)	(0.936)	(1.274)	(1.051)	(0.157)	(2.225)	(1.313)
SSA	0.0304	0.0135	0.0302	-0.00938	0.0118	-0.00254	0.0360	-0.0255
	(0.937)	(0.410)	(0.979)	(0.115)	(0.466)	(0.102)	(1.502)	(0.430)
MENA	0.0631**	0.0599*	0.0559	0.119	0.0460**	0.0415*	0.0648***	0.0448
	(2.265)	(1.975)	(1.501)	(1.626)	(2.057)	(1.775)	(3.370)	(1.083)
High income countries					0.0327**	0.0312**	0.0456***	0.0395**
					(2.208)	(2.073)	(2.701)	(2.239)
Observations	52	52	38	35	78	78	63	59
R-squared	0.751	0.717	0.820	0.844	0.750	0.724	0.813	0.803
Adj. R-squared	0.620	0.567	0.658	0.660	0.669	0.635	0.733	0.702

Annex II: Summary Statistics and Correlation Matrix

Summary Statistics, 2000-2005 world sample

Variable	No. Obs. (Countries)	Mean	Standard Deviation	Min	Max
Inward FDI/GDP Growth	78	0.047849	0.056528	-0.1653	0.169577
Inward FDI/GDP Stock	78	33.44786	24.95549	1.521672	132.9266
Human Capital Growth	78	0.017685	0.011039	-0.01034	0.048578
Corporate Tax Reduction	78	0.014498	0.028767	-0.09885	0.100688
Energy Loss Reduction	77	0.012179	0.050157	-0.22063	0.173316
Natural resource per capita	78	13.09878	22.55607	1.192	169.15
Financial Sector Development Growth	72	0.039427	0.052276	-0.06018	0.209108
Trade Liberalization Growth	78	0.035777	0.088296	-0.26995	0.374208
Investment Policy Openness Growth	78	-0.00519	0.026108	-0.07879	0.070707
Macroeconomic Stability	77	-0.0024	0.059492	-0.16384	0.150653
Control of Corruption Changes	78	-0.00557	0.035648	-0.14866	0.102065
ICT Infrastructure Growth	78	0.180361	0.113777	0.028388	0.483358
Political Stability Changes	78	-0.01869	0.123197	-1	0.208901
Road Infrastructure Growth	66	0.003774	0.041965	-0.16662	0.146267
Real Wage Growth	62	-5.63332	4.522851	-20.1918	0.252715

Summary statistics belongs to the variables within 2000-2010 period for the countries included in the base model.

Correlation Matrix

	Growth Inward FDI/GDP	Inward FDI/GDP Stock	Human Capital Growth	Corporate Tax Reduction	Energy Loss Reduction	Natural Resource (pc)	Financial Developme nt Growth	Trade Liberalizati on Growth	Investment Policy Openness	Macroecon omic stability	Control of Corruption Changes	ICT Infrastructu re Growth	Political Stability Changes	Road Infrastructu re Growth	Real Wage Growth
Growth Inward FDI/GDP	1														
Inward FDI/GDP Stock	-0.0733	1													
Human Capital Growth	-0.0853	-0.0931	1												
Corporate Tax Reduction	0.0227	-0.035	0.256	1											
Energy Loss Reduction	0.0158	-0.1135	0.0744	0.0193	1										
Natural resources (pc)	0.1691	-0.0308	-0.2818	-0.0514	-0.3047	1									
Financial Development	0.066	-0.1282	-0.1684	0.14	0.1493	-0.006	1								
Trade Liberalization	0.2203	-0.0046	0.1847	0.2481	0.034	0.0159	0.1141	1							
Investment Openness	0.1465	0.0037	0.0425	0.1615	-0.1171	0.2012	0.0899	0.1165	1						
Macroeconomic stability	-0.093	-0.0676	0.3151	0.0184	-0.0152	-0.1476	-0.0541	-0.074	-0.1209	1					
Control of Corruption	0.0926	0.0309	-0.0009	-0.0057	-0.1073	0.0377	0.0753	-0.0191	0.219	-0.0122	1				
ICT Infrastructure	0.0077	-0.2717	0.3054	-0.1002	0.109	-0.279	0.2322	-0.0088	0.0525	0.1938	0.0678	1			
Political Stability	-0.1408	0.044	-0.1218	-0.0343	-0.0193	0.0007	0.2234	0.005	0.0782	0.0906	0.0721	0.0406	1		
Road Infrastructure	0.0785	-0.0011	-0.0623	-0.081	0.1504	-0.1425	0.0071	0.0208	-0.0038	0.0602	-0.0361	0.0826	-0.0598	1	
Real Wage Growth	0.1458	0.1583	0.0674	0.0763	-0.2337	0.1127	-0.175	-0.0964	0.4681	-0.113	0.2753	-0.3462	0.0011	0.0234	1

All variables belong to 2000-2010 time period.

Annex III: Country Perspectives: Recent Developments and Trends in South Asia's FDI Inflows

India

Post financial crisis, the service sector in India is showing a strong recovery. As mentioned above, most of India's FDI inflows are concentrated in the service sector, going into activities that include financial services, banking, insurance, non-financial and business services, outsourcing, research and development, courier services, technical testing and analysis.

A large influx of foreign capital into India's financial industry occurred in the past decade, mainly from international financial corporations. In addition, India has become the preferred outsourcing location for foreign companies setting up call and service centers. For India, this activity provides significant and stable foreign-capital inflows. The financial crisis had a large impact on this sector, bringing declines in 2009 and 2010. However, the latest numbers show steady recovery in 2011 and 2012.

Telecommunication is another FDI magnet, with most investments going into telephone services. Since 2005, up to 74 percent foreign ownership has been allowed into the telecommunication and telecom sector. Inward FDI reached a peak in 2009 at 123.7 billion rupees. Like services, telecommunication was hurt by the crisis. Inward FDI numbers fell by nearly a half in 2010, but bounced back quickly in 2011. Computer software and hardware, although a business in decline, is still a significant share of FDI into India. In the past decade, many international IT brand names have made investments in India.

The pre-crisis years were marked by strong growth of FDI into the real estate and construction sectors; however, post-crisis FDI has experienced a drastic fall in real estate while robust growth returned to infrastructure construction. In 2005, the government of India started to allow 100 percent foreign ownership in real estate and infrastructure projects. As a result, a large amount of foreign capital has been invested in these sectors. For the two sectors combined, FDI peaked in 2009, surpassing financial, business, and other services to be the top sectoral destination in India. Since then, real-estate FDI has gone downhill. Due to the deterioration of India's housing market, the amount of foreign capital flowing into real estate fell more than 80 percent from 2009 to 2011. By contrast, infrastructure construction, also impacted by these macro factors, has been more resilient and is showing robust growth after the crisis. From April 2011 to March 2012, infrastructure FDI tripled from its year-earlier level, becoming larger than FDI in telecommunications.

The growth of the Indian automobile industry has been impressive, mainly driven by an increase in domestic demand. Overall, India's automobile production grew 13.8 percent from 2011 to 2012, with sales increasing 12.5 percent. The automobile industry is a significant presence in India's total inward FDI, although inflows weakened in 2011. So far, each of the international car makers—Nissan, Suzuki, Mercedes-Benz, Ford, Volkswagen, Hyundai, Honda and Toyota—has invested more than US$1 billion dollars in the country. The sector presents immense prospects. The Society of Indian Automobile Manufacturers (SIAM) forecasts growth of up to 13 percent for 2013. Policy has been supportive. The industry is 100 percent open for FDI, and the government has been pursuing a plan to accelerate and sustain automotive industry growth from 2006 through 2016. This plan aims to make India a global automotive hub, with exports of small cars and auto components. Besides policy concessions towards automobile exports, the government is spending US$400 million to create state-of-art testing and R&D facilities across the country. As the fourth biggest steel producer in the world, India is poised to meet the automobile industry's increasing demand.

India's pharmaceutical and chemical industries have great potential for attracting more FDI in the future. The pharmaceutical sector was opened to 100 percent FDI a decade ago, but inward FDI has taken off only recently. A series of foreign mergers and acquisitions of Indian pharmaceutical companies has taken place since 2010—most notably, Abbott Laboratories' acquisition of Piramal Healthcare for US$3.6 billion. In response to more frequent and larger foreign acquisitions, the Reserve Bank of India decided in December 2011 to regulate FDI into pharmaceutical sector by making mergers and acquisitions subject to government's approval. In the chemical industry, inward FDI flows have registered steady growth in the past few years. Now, 100 percent foreign ownership is allowed, and most chemical products no longer need licenses. In addition, the government is setting up port-based chemical parks in Special Economic Zones (SEZ) to provide better infrastructure and grant tax concessions. With its national network of more than 200 national laboratories and 1,300 R&D units, India's pharmaceutical and chemical industries have steadily moved toward being an international R&D hub for multinational corporations.

India: Leading Sectoral FDI inflows 2000-11

Sectors		2000-05	2006	2007	2008	2009	2010	2011
Business, Financial, Miscellaneous Services and R&D/1	*billion Rs*	77.4	175.0	145.1	339.5	272.4	161.5	238.9
	% total FDI	8.1	34.8	18.2	24.3	20.8	16.8	18.8
Telecommunications	*billion Rs*	72.6	41.7	43.5	116.0	123.7	69.1	104.9
	% total FDI	7.6	8.3	5.5	8.3	9.4	7.2	8.2
Construction Development /2	*billion Rs*	17.6	36.6	51.9	103.6	116.8	71.1	85.0
	% total FDI	1.8	7.3	6.5	7.4	8.9	7.4	6.7
Computer Software & Hardware	*billion Rs*	122.2	87.5	102.1	78.1	32.1	45.3	31.4
	% total FDI	12.8	17.4	12.8	5.6	2.5	4.7	2.5
Housing & Real Estate	*billion Rs*	2.1	21.2	60.6	113.5	159.7	72.4	30.2
	% total FDI	0.2	4.2	7.6	8.1	12.2	7.5	2.4
Automobile	*billion Rs*	64.9	11.8	14.9	48.1	67.3	56.6	39.3
	% total FDI	6.8	2.3	1.9	3.4	5.1	5.9	3.1
Drugs & Pharmaceuticals	*billion Rs*	32.3	9.8	11.4	11.1	9.8	10.0	145.3
	% total FDI	3.4	1.9	1.4	0.8	0.7	1.0	11.4
Chemicals	*billion Rs*	32.2	17.9	10.2	26.4	22.1	20.5	30.3
	% total FDI	3.4	3.6	1.3	1.9	1.7	2.1	2.4

Source: SIA Newsletters (Department of Industrial Policy & Promotion, Ministry of Commerce & Industry) and World Bank staff calculations.

1/This category includes subcategories of financial services, banking services, insurance, non-financial and business services, outsourcing, research and development, courier services, technical testing and analysis, and other services.

2/ Construction development includes constructions of roads and highways, warehouses, and other infrastructure projects.

Bangladesh

Bangladesh's inward FDI is mostly concentrated in the service sector. Taken together, the telecommunication and banking sectors contributed to 72 percent of total FDI flowing into the country in 2009. In the past couple of years, however, inward FDI into the service sector has weakened due to a decline in telecommunications FDI. The sector had attracted the largest amount of FDI in 2005-10, but it suffered a drastic 95.6 percent plunge in FDI in 2011. Other sectors in services and banking performed better after the global crisis. The volume of inward FDI flows in services and banking almost doubled from 2010 to 2011, contributing 27 percent of total inward FDI.

Increasing wages in China have allowed Bangladesh to benefit from its comparative advantage in low labor costs. Foreign companies often cite low labor costs as the most important factor in investing in Bangladesh. The garment industry in particular has been a success story, spurred by the country's abundant labor. It is the largest manufacturing sector of the country, employing more than 5 million people, or 10 percent of total employment. Textile products account for 80 percent of the country's exports. The inward FDI flow in textiles has increased steadily over the past few years; in 2011, it reached 30 percent of the total FDI. Increasing labor costs in China, the world's major textile manufacturer, are boosting Bangladesh's prospects in the garment industry. Countries like Japan opt for a "China plus one" trade strategy to reduce dependence on China. Recently, Bangladesh has received

an increasing number of investments by international brand names in clothing and accessories, such as Esprit (Hong Kong), Uniqlo (Japan), and YKK (Japan).

Inward FDI flows into Bangladesh's power sector have accelerated due to favorable government policies. At present, only 48.5 percent of the population has access to electricity, and per capita power generation is low compared to other developing countries. The government has given the power sector the highest development priority, with its goal of making electricity available to all by 2021. A number of facilities and incentives are provided to foreign investors, such as tax exemptions and easier access to finance. As a result, FDI flows into the power sector have seen robust growth in the past few years. Energy Holdings International Inc., a U.S. company, is reportedly building a 450 megawatt plant. Although still recovering from the crisis, the gas and petroleum industry, which is closely related to the power industry, more than doubled its growth in 2011.

Bangladesh: Leading Sectoral FDI inflows 2000-11

Sectors		2000-05	2006	2007	2008	2009	2010	2011
Telecommunication	*million USD*	394	268	305	300	580	446	52
	% total FDI	16.2	36.0	38.4	39.0	60.3	48.8	6.7
Textiles	*million USD*	364	74	105	93	130	158	225
	% total FDI	15.0	9.9	13.3	12.2	13.6	17.3	28.9
Gas and Petroleum	*million USD*	467	182	205	133	23	37	74.6
	% total FDI	19.2	24.4	25.9	17.3	2.4	4.0	9.6
Banking	*million USD*	256	130	92	157	110	112	209
	% total FDI	10.5	17.5	11.6	20.4	11.5	12.2	26.8
Power	*million USD*	**367**	27	25	25	23	37	53
	% total FDI	15.1	3.7	3.1	3.3	2.4	4.0	6.8

Source: *Foreign Direct Investment in Bangladesh Survey Report 2011*, Statistics Department, Bangladesh Bank

Pakistan

FDI into Pakistan's service sector has diminished recently, affected by the global financial crisis. The telecommunication sector has been open to foreign investment. Telecommunications accounted for more than half of the total value of FDI flowing into Pakistan in 2006. Since then, FDI in the telecommunication sector has declined every year, culminating in a sharp 79 percent drop in 2011. Recent data indicate an outflow of US$346.4 million from July 2001 to May 2012. Foreign investors have been either reluctant to put in additional capital or pulled capital out of the sector due to the increasing competition and diminishing revenues in cellular operations, worsened by a setback in promoting 3G licensing in the country. The financial services sector has also seen a post-crisis fall; however, it recorded a small rebound in 2011. In 2012, the banking sector saw heavier outflows than inflows of foreign capital, resulting in an 82 percent drop in FDI.

Pakistan's energy sector has the potential to attract more inward FDI flows, which could in turn alleviate the country's problem with electricity shortages. Pakistan has the fourth largest reservoir of coal at 185 billion tons, estimated to be worth US$25 trillion. The oil and gas exploration sector is now Pakistan's No. 1 FDI magnet, already reaping large investments from the United States, the EU and China. The sector's inward FDI flows have been progressively increasing every year, reaching 70 percent of total inward FDI in fiscal year of 2012. Despite its great potential for generating electricity with coal, Pakistan currently is suffering serious energy shortages. At one point, the gap between supply and demand hit 7,500 megawatts, equivalent to 40 percent of national demand. FDI to build more capacity in the power sector may be a good solution to the country's electricity deficit. But while Chinese, Turkish, Saudi Arabian, and Finnish power companies have invested in this sector since 2008, flows into this sector have not been stable due to uncertainty in the institutional framework to support FDI in this sector.

Pakistan: Leading Sectoral FDI inflows 2002-11

Sectors		2002-05	2006	2007	2008	2009	2010	2011	2012p*
Telecommunication	*million USD*	721	1905	1824	1440	815	374	79	-346
	% total FDI	19.2	54.1	35.5	26.6	21.9	17.4	4.8	-45.8
Financial Business	*million USD*	723	329	930	1865	708	163	310	56
	% total FDI	19.2	9.3	18.1	34.5	19.0	7.6	19.0	7.4
Oil and Gas Explorations	*million USD*	851	313	545	635	775	741	512	526
	% total FDI	22.7	8.9	10.6	11.7	20.8	34.4	31.3	69.5
Trade	*million USD*	161	118	173	176	167	117	53	23
	% total FDI	4.3	3.4	3.4	3.3	4.5	5.4	3.2	3.1
Power (Thermal)	*million USD*	90	320	202	60	109	-126	150	-28
	% total FDI	2.4	9.1	3.9	1.1	2.9	-5.9	9.2	-3.7

Source: State Bank of Pakistan

Note: Fiscal year-ends are in June. *Eleven months from July 2011 to May 2012.

Sri Lanka

The post-war period was marked by strong growth in inward FDI flows, especially in the telecommunications, power, and manufacturing sectors, but trends are changing with the service sector now becoming an even more dominant FDI magnet. Inward FDI flows to Sri Lanka were impacted by the global financial crisis, falling by 32 percent in 2009 and 14 percent in 2010. The telecommunications and power sectors were the leading inward FDI sectors in 2009; in 2010, growth shifted toward manufacturing, services (excluding infrastructure), and agriculture. As a share of overall FDI inflows in 2010, manufacturing was 30.9 percent, services were 8.6 percent, and agriculture was 1.3 percent. In 2011, Sri Lanka recorded its highest-ever FDI inflows, more than doubling the previous year's inflows. This reflects investor confidence, with improvements of the country's rankings in global competitiveness and ease of doing business indices.

The rapid growth in Sri Lanka's tourism industry has fueled a large influx of foreign capital into infrastructure and hotel projects. Post conflict, the Sri Lankan government has moved toward a services-oriented economy, with particular emphasis on promoting tourism and Information, Communications and Technology (ICT). Dividends are evident. Tourism arrivals rose 46 percent from 2009 to 2010, followed by a 31 percent rise from 2010 to 2011. The hotel and restaurant sector attracted the largest amount of FDI inflows, accounting for some 20 percent of total FDI. Key FDI inflows include the Shangri-La hotel chain's investment of around US$500 million for constructing luxury hotels in Colombo and Hambantota. Sheraton Group has invested about US$300 million to develop a hotel. In the pipeline is a US$800 million investment by South Africa's Sun City resorts. The telecommunication sector, which had been dominant in the recent past, ranked second in 2011 with 18 percent of total FDI.

Afghanistan

Over the past few years, Afghanistan has shown signs of recovering from it long war, attracting large inward FDI flows into resource-related projects. The country is endowed with a wealth of natural resources, and most FDI has gone into extraction and the transport and logistics industries. Chinese corporations have made large deals in the natural resources sector, with investments of US$228 million from the Jiangxi Cooper, US$2.9 billion from China Metallurgical Group, and US$300 million from National Petroleum Corporation. TTL Shipping & Logistics, a United Arab Emirates (UAE) company, has also made significant investments in transportation and logistics.

Bhutan

A new FDI framework has opened Bhutan's doors to foreign investors, enticing them to take advantage of opportunities in the hydropower sector. The Royal Government of Bhutan (RGoB) enacted a new FDI policy in May 2010, which allows for 100 percent foreign ownership in some sectors. Before the new law, there had been a number of joint ventures, most notably Bhutan Ferro Alloys by a Japanese company and RGoB, plus a few Indian companies opening branches in Bhutan. After the new FDI policy, Mountain Hazelnut Venture (MHV) became Bhutan's first 100 percent foreign-owned company, producing hazelnuts for export in a sustainable and environmentally conscious way. India has collaborated with Bhutan to take advantages of the country's valuable natural resources to provide much-needed electricity to households.

Maldives

As South Asia's most popular tourist attraction, the Maldives leads the region in inward FDI/GDP ratio and its major FDI projects are in hotels and real estate. In the past few years, international hotel and resort chains have made significant investment in the Maldives—Four Seasons (US), Regent (US), Jumeirah International (UAE), Centara (Thailand), TUI AG (Germany), Viceroy (UAE), Raffles (Canada), Shangri-La (Hong Kong), and Six Senses (Thailand). Companies from Malaysia and India have formed a large number of joint ventures in Maldives' residential real estate. Investments from India and Malaysia built Ibrahim Nasir International airport, Male's largest airport.

Nepal

Very little FDI has found its way to Nepal, but the country's tremendous potential in hydropower offers an untapped opportunity that could be lucrative for foreign investors. In Nepal, only 40 percent of the population has access to electricity. More foreign investment in the power sector can potentially close the gap between the supply and demand of electricity. So far, India and China have made significant investments in mega hydropower projects. India is Nepal's main trading partner, and it has contributed the most foreign capital to Nepal. Indian companies have invested in a wide spectrum of sectors, including telecommunications, transportation, hydropower, hotels, metals, food, ceramics, and textiles.

Annex IV: Country Perspectives: Recent Developments and Likely Trends in South Asia's FDI Outflows

India

Thanks to liberalization, India's outward FDI has registered phenomenal growth over the past decade. Over the past decade, India's average annual growth in outward FDI has been approximately 48.8 percent. The country was in the top 20 of FDI-outflow economies in 2010-11. Among the emerging economies, the value of India's 2011 outward FDI in 2011 was similar to the levels of Brazil and Russia and a quarter of the outward FDI from China (including Hong Kong, Macau and Taiwan).

Although Indian firms have invested abroad since the early 1970s, their investments were small until the mid-1990s. Growth in outward FDI occurred after liberalization of policies governing these investments and fast-track investments up to US$4 million were permitted. India's outward FDI suddenly jumped to US$1.5 billion in 2000. Outward investment from India has experienced another round of significant increases since 2006—,after a series of efforts to further liberalize policies by permitting Indian commercial banks to extend credit for Indian company's outward investment in 2003 and raising the for prudential limit on bank financing in 2006 (Kumar 2008).

India's outward FDI is mainly in the services and manufacturing sectors (see table below). Since late 1990s, high-tech firms have been active outward investors. IT firms such as Tata Consultancy Services, Infosys, WIPRO, and Satyam acquired global contracts and established offices in developed economies to be close to their clients. Within the services sector, business services, data processing, financial services, engineering services are the major activities with Indian outward investment. Manufacturing investment has flowed into agriculture machinery, chemicals, drugs, medicine products, and other industries.

Major Sectors for Overseas Investments by Indian Companies
(in billion USD)

Period	2008-09	2009-10	2010-11	2011-12*	Total
Manufacturing	10.18	5.35	5.04	2.74	**23.31**
Financial Insurance, Real Estate Business and Business Services	3.55	4.41	6.53	2.53	**17.03**
Wholesale & Retail Trade, Restaurants & Hotels	1.17	1.13	1.89	1	**5.19**
Agriculture & allied activities	2.38	0.95	1.21	0.41	**4.94**
Transport, Communication & Storage Services	0.31	0.38	0.82	1.34	**2.85**
Construction	0.35	0.36	0.38	0.37	**1.46**
Community, Social & Personal Services	0.39	0.18	0.7	0.18	**1.45**
Electricity, Gas & Water	0.14	0.84	0.1	0.04	**1.19**
Miscellaneous	0.12	0.11	0.18	0.1	**0.51**
Total	**18.58**	**13.71**	**16.84**	**8.73**	**57.86**

* April 2011 to February 22, 2012. Source: Reserve Bank of India, March 2012

Liberalization of the investment regime permitted access to foreign markets though brand-name acquisitions in developed economies. India's Tata Tea bought Tetley for US$407 million in 2000. It was the first time an Indian company acquired a major industry leader in one of the advanced economies; now, Tata Tea has become the second largest tea manufacturer and distributor in the world. Since 2007 a series of mega-acquisitions targeted industrial

leaders, notably Tata Steel's US$13.3 billion acquisition of Corus, a steel-maker; Bharti Airtel's US$10.7 billion purchase of Zain, a mobile-telecom firm; Hindalco (part of Aditya Birla)'s US$6.2 billion takeover of Novelis, an aluminum firm; and Tata Motors' US$2.3 billion acquisition of Jaguar Land Rover.

Recently India has had rapid growth in outward FDI flows into extractive industries due to rising demand for oil, gas, and minerals to support industrialization and urbanization. Large Indian companies have increasingly been acquiring mineral assets abroad. State-owned Oil and Natural Gas Corporation Ltd. (ONGC) has overseas asset in 14 countries of the Middle East, Asia, Africa, and Latin America. ONGC's recent investments include development of the Sakhalin I oil project in Russia, and the purchase of the Carabobo block in Venezuela, joining Indian Oil Corporation (IOC) and Oil India Ltd. Oil India invested mainly in exploration blocks in Iran and Africa—Gabon, Libya, Nigeria, and Sudan. Coal India Ltd., the world's largest coal miner, has also acquired coal and mineral mines overseas. Looking beyond the state-owned companies, Reliance Group, India's largest private company, has built up an international portfolio of resources in Peru, Yemen, Oman, Colombia, Australia, and other countries. India has stepped up its effort of cross-border investment in natural resources over the past few years; however, the magnitude of those acquisitions is still dwarfed by investment from other emerging giants, such as China and Brazil.

Top Ten countries for Overseas Investments by Indian Companies
(in billion USD)

Country	2008-09	2009-10	2010-11	2011-12*	Total
Singapore	4.06	4.2	3.99	1.86	**14.11**
Mauritius	2.08	2.15	5.08	2.27	**11.57**
Netherlands	2.79	1.53	1.52	0.7	**6.54**
United States	1.02	0.87	1.21	0.87	**3.97**
United Arab Emirates	0.63	0.64	0.86	0.38	**2.51**
British Virgin Islands	0	0.75	0.28	0.52	**1.55**
United Kingdom	0.35	0.34	0.4	0.44	**1.53**
Cayman Islands	0	0.04	0.44	0.14	**0.62**
Hong Kong	0	0	0.16	0.31	**0.46**
Switzerland	0	0	0.25	0.16	**0.41**
Other countries	7.65	3.19	2.65	1.23	**14.71**
Total	**18.58**	**13.71**	**16.84**	**8.86**	**57.98**

*April 2011 to February 28, 2012. Source: Reserve Bank of India, March 2012

Outbound FDI from the rest of South Asia are much smaller. Despite the scarcity of detailed outward FDI statistics for the rest of South Asia, a number of reports show traces of investment overseas for Pakistan and Sri Lanka. By 2009, more than 6,000 Pakistani firms were registered and operating in the UAE, where more than 1.2 million Pakistanis reside—second only to Indians among migrant populations. The situation is similar for Sri Lankan firms in the UAE. Due to energy shortages and security concerns, some Pakistani textile companies have relocated to Bangladesh. Aitken Spence PLC, a Sri Lanka conglomerate, has invested in hotels in India, the Maldives, and Oman. MAS Holdings and Bandix Lanka, Sri Lanka's largest garment manufacturers, also have significant investments overseas.

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