Working Paper 218

Regional Economic Integration and FDI in South Asia : Prospects and Problems

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July 2008

INDIAN COUNCIL FOR RESEARCH ON INTERNATIONAL ECONOMIC RELATIONS

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Foreword

The emergence of ‘new regionalism’ is redefining regional cooperation and regional trade agreements, the world over. The elements of deeper regional integration incorporated in the currently proliferating RTAs go well beyond the traditional modalities for economic cooperation. They aim at strengthening a region’s participation in global production networks both through trade and capital flows. The present study argues that there is need to forge deeper integration within the South Asia region. It analyses the factors that can impede growth of both intra and extra regional FDI flows and explores how these constraints may be addressed through greater economic integration. The study concludes that a deeper form of cooperation is an urgent necessity for the region for promoting FDI. I hope this study will result in a better understanding of the issues related to promoting deeper economic integration in South Asia.

(Rajiv Kumar)
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July 30, 2008

Abstract

The slow progress and modest achievements of regional integration in South Asia have generated a huge amount of skepticism about its role as an effective strategy of growth. The present study, however, argues that there is need to forge deeper integration within the region. It examines the prospects and problems of serious fiscal consolidation within the area. Essentially, it looks at the effect of deepened regionalism on investment flows. It argues that regional integration has the potential to promote intra and extra regional FDI flows and economic development in individual countries of the region. This will pave the way for the most efficient use of the region's resources through additional economies of scale, value addition, employment and diffusion of technology. A number of challenges remain. Structural weaknesses, institutional bottlenecks, political movements, narrow nationalism and mutual mistrust are some of the factors that explain the failure of the region to exploit possibilities. Paradoxically, the problems themselves provide strong motivation for strengthening cooperation. It is only through more intensive collaboration that these complexities can be addressed and resolved.

Key Words: *Regional integration, South Asia, intra regional FDI, extra regional FDI, SAFTA*

JEL Classification: *F15 F21 F23*

Regional Economic Integration and FDI in South Asia: Prospects and Problems

Aradhna Aggarwal

I. Introduction

The number of Regional Trade Agreements (RTAs)[1] has been rising exponentially. In 1990, there were only about 40 accords in operation (Crawford and Laird 2000). By July 2007, some 380 had been notified to the GATT/WTO. Of these, 205 were in force (WTO, 2008). There is a view that the figure of operational RTAs could escalate up to 400 by 2010 (Panitchpakdi, 2007). Proposals among developing countries have also been mounting in a hurry. Several are being negotiated and more being studied. According to Lamy (2006) in excess of 50 per cent of global trade is conducted through RTAs.

The need to attract foreign investment has been cited as an impetus for RTAs (see, for example, Balasubramanyam and Greenaway 1993). Traditionally, they aimed to lower trade barriers. However, most in recent years have moved beyond the trade barrier reducing exercise and involve specific commitments on investment[2]. These accords are sometimes referred to as "comprehensive preferential trade and investment agreements" or PTIAs (UNCTAD 2006) or "new generation RTAs". Economic integration in the form of PTIAs has become the nucleus of development strategy, especially for developing countries. According to UNCTAD 2006, as of end 2005, developing countries were parties to 79 per cent of the PTIA network, while developed countries were involved in 54 per cent of the agreements. South-South PTIAs have also increased to reach 86 RTAs at the end of 2005 (UNCTAD 2006a). In addition, as of July 1, 2006, at least 67 were under negotiation, involving 106 countries.

The emergence of "new generation RTAs" has had a substantial effect on theoretical and empirical literature. This body of work argues that RTAs affect FDI flows not only through investment-specific provisions but also preferential trade-related conditions and other initiatives contained in them. The relationship between regional agreements and FDI flows is, however, complex and the outcome is determined by many factors, including the degree of integration, the nature of capital flows, the patterns of trade and FDI, the structural composition and the level of development of partner countries.

The objective of the present study is to examine whether regional initiatives undertaken in South Asia have had a favourable impact on foreign direct investment. It qualitatively examines the trends and patterns of intra-regional investment flows within the broad framework of the South Asian Association for Regional Cooperation (SAARC), assesses future prospects of regional FDI, explores policy options for partner countries in the changing policy environment, investigates challenges faced in

[1] RTAs are sometimes referred to as economic integration agreements (see, UNCTAD 2006 and references therein)

[2] Therefore, the new wave of RTAs is generally referred to as "new regionalism" (see Burfisher et al 2003, Holmes et al. 2006 for discussion).

exploiting the potential of regional initiatives and identifies lessons to emulate East Asia's success story.

The analysis is organized into seven sections. Section 2 provides a comprehensive overview of the theoretical and empirical literature on the impact of regional integration on FDI flows. Section 3 describes current efforts at strengthening regional cooperation and integration in South Asia and its relevance. Section 4 then examines magnitudes and patterns of FDI flows both intra and extra regional, in the region. Section 5 looks at the future prospects of intra regional investment flows. Section 6 analyses the challenges and constraints that need to be addressed to promote FDI flows into the region. Finally Section 7 concludes the analysis.

2. Regional Integration, Trade and FDI: Overview of Literature

2.1 Theoretical Literature

Theoretically, there are three broad categories of provisions through which RTAs influence FDI flows in the integrating regions (see for instance, Borenzstein and Lee 1995, Blomström and Kokko 1997, Dunning 1997): preferential trade terms, investment –related stipulations and other forms of cooperation. Each of these effects is discussed below.

Preferential trade provisions induced effects on investment*:* Preferential trade conditions which aim at removing internal tariff barriers can affect both, intra-regional FDI flows (generated in integrating countries) and extra regional FDI (generated outside the region). Studies distinguish between static and dynamic linkages between preferential trade provisions and FDI.

In *static terms*, the nature of the impact of trade-related provisions on intra-regional FDI would be determined by the motive and nature of pre-agreement intra regional investment (Blomstrom and Kokko 1997). The removal of trade barriers between integrating countries can lower intra-regional FDI when it is mainly of a market -seeking or tariff -jumping nature. With lowered trade barriers, companies with high fixed costs may concentrate their activity in one country and serve the partner markets through exports rather than set up subsidiaries in each of them. In this sense, one can say that trade would substitute investment and the RTA would have a negative effect on intra regional investment patterns. If, on the other hand, intra regional investment is of an efficiency-seeking nature, an RTA would affect it desirably because freer trade of goods and services enables companies to establish different elements of the production process in locations where competitive conditions are most beneficial to it. In this instance, investment complements trade.

Nonetheless, one cannot rule out the possibility that the formation of an RTA itself would change the balance between vertical and horizontal FDI in member countries, resulting in some increase in the former at the expense of the latter. Implementation of the North American Free Trade Area (NAFTA), for instance, made production sharing between the US and Mexico in the automobile sector possible. While the manufacturing of parts and components was concentrated in the US, labour- intensive assembly operations were transfered to Mexico. This resulted in a significant increase in FDI flows into Mexico. The Rules of Origin riders can also encourage the use of intra-regional inputs diverting extra-regional inputs, even if these were more efficient. This would also promote intra-regional efficiency seeking FDI (Velde and Bezemer 2006). Finally, trade liberalisation opens up possibilities of cross-border investment in trade, transport and distribution for partners which can promote intra-regional FDI in services.

Extra-regional FDI may also be affected by the preferential trade stipulations of the RTAs in different ways. First, RTAs may raise the fear of future protection for external investors, inducing them to venture inside the area and earn the status of being insiders (Blomstrom and Kokko 1997). Second, RTAs expand the market size of individual countries by lowering tariffs and thus overcome the disadvantages of small economies. It may therefore become profitable for an extra-regional investor to have access to a larger market (Jaumotte 2004, Lederman, and others 2004 for empirical analysis). Third, lowering of non-tariff barriers within an RTA may provide an incentive to extra-regional investors to set up operations inside the region. Evidence suggests that the elimination of the use of anti-dumping measures within the European Union motivated the Japanese to set up operations inside the EU (Ray Barrell and Nigel Pain 1999, Girma et.al 2002).

The *dynamic effects* of RTAs on FDI are analysed within the framework of the new trade theories (Ethier 1998). While emphasizing the trade-productivity-growth links, the studies are bringing to light the potential of RTAs increasing the appeal of the region by promoting trade-oriented economic growth (Baldwin 1989). The creation of an RTA may stimulate virtual competition between the participating countries, driving them to improve their investment environment to the best available in the region (Jaumotte 2004). In addition, a larger market provides opportunities to firms to grow and become more competitive. This may lead to the creation of intangible assets and thereby stimulate more investment. Finally, FDI may itself catalyse the growth of the economy and contribute further to its own expansion by promoting technology transfers and spillovers.

Effects of Investment-related Provisions: Investment provisions in RTAs consist of rules on pre and post entry treatment, protection of FDI and expropriation and dispute settlement mechanisms. These regulations liberalise FDI flows by reducing/eliminating restrictions on the entry and ownership of foreign investors and by ensuring that they do not suffer in treatment in comparison with their domestic counterparts. The investment rules guarantee a predictable investment climate and enhance investors' confidence on the legal and political milieu, particularly in low and middle income countries (Velde and Bezemer 2006). RTAs may have positive effects on FDI inflows to the extent that the investment provisions lower barriers and facilitate capital flows.

Other Forms of Regional Initiatives: RTAs cover various forms of regional co-operation other than trade and investment terms. These include cross-border movement of people, across-border transaction of funds, better information flows, publication of data and statistics, contract enforcement and so on. Some regions (ANDEAN, ASEAN, MERCOSUR) have cooperation schemes which aim to establish regional enterprises by promoting joint ventures. Thus RTAs are not about merely setting trade and investment rules. They improve the economic climate and hence promote trade and investment activities.

2.2 Empirical Studies

Two approaches have been adopted to assess the impact of RTAs on FDI: the case study based method and the cross-RTA approach.

Studies using the first procedure focus on a specific RTA and analyse its effect on FDI inflows in integrating partners and /or excluded countries, either qualitatively or by using quantitative tools. The findings of some of these studies are described in Table 1.

Table 1 : RTAs and FDI flows: Selected Studies based on case-study approach

RTA	Authors	Findings
EU	Pelkmans 1984, Dunning 1997, Srinivasan and Mody 1997, Brenton *et al.*1998, Pain and Landsbury 1996	• Positive FDI effects; • Disagreement over whether the positive effects were due to intra-regional or extra regional FDI
NAFTA	DFAIT 1999 Blomstorm and Kokko 1997, A. Monge-Naranjo 2002, Waldkirch 2003	• Positive FDI effects; • Disagreement over whether the positive effects were due to intra-regional or extra regional FDI
MERCOSUR	Blomström and Kokko 1997	• Strong positive impact. • Unequal distribution of the inflows of FDI among participating countries[3].
ASEAN	Jeon and Stone 2000	• Increase in intra-bloc FDI
Korea-U.S. FTA	Kang and Park 2004	• Increase in FDI by 14-35% from member countries and by 28%-35% from non-member countries.

The cross- RTA approach based analyses use econometric models of FDI, in which one of the explanatory variables is a dummy describing whether or not a country is a member of a regional grouping. Findings of these studies are summarized in Table 2.

[3] While Argentina and Brazil were found to benefit significantly, the experiences of Uruguay and Paraguay were mixed

Table 2 : RTAs and FDI flows: Selected Studies based on cross RTA approach

Study	Dataset	Findings
Stein and Duade (2001)	Sample of 60 countries	• Positive but insignificant effect of RTAs.
Adams et al. (2003)	A panel of high-income and developing countries over 1988-1997	• Investment effects of RTAs come from non-trade provisions. • Countries with larger post-RTA market size, and better economic fundamentals benefit more.
Yeyati et al. (2003)	OECD countries over 1982-1999	• Positive effects on FDI. • Benefits are unlikely to be distributed evenly.
Jaumotte (2004)	South-South RTAs with 71 developing countries during 1980–99	• The RTA market size and the size of domestic population had a positive impact on the FDI. • Not all countries in the RTA benefited to the same extent from the RTA. [4]
Velde & Bezemer (2006)	Developing countries over 1980-2001	• The type of regional grouping matters i.e. whether or not RTA include certain trade and investment provisions.[5] • Within a regional grouping, the position of countries within a region matters.[6]
Baltagi et al. (2007)	Europe over 1989-2001	• RTA increases FDI up to by 78% among European countries.
World Bank 2005	152 countries with 238 RTAs over the 1980–2002 period	• RTA may help governments improve the investment climate and bring in more investment but is no substitute for an adequate investment climate.
Leshier and Miroudot (2006)	All North-South RTAs in which I-provisions were substantive during 1990-2004	• Investment provisions in RTAs are positively associated with both trade and investment flows. • The results are more profound for FDI flows than trade flows.
Medvedev (2006)	A panel of 143 countries over 1980–2003	• FDI benefits of RTAs increase with the size of PTA partners. • The effect is due mostly to North-South and deep integration Agreements.

[4] Countries with relatively higher education and financial stability tend to attract a larger share of the FDI at the expense of other RTA members.

[5] Formation of some RTAs (CARICOM, ASEAN, ANDEAN, NAFTA) succeeded in attracting additional extra-regional FDI while this is not true for some others (SADC, COMESA and MERCOSUR).

[6] Smaller countries and countries located further away from the largest country in the region benefit less from being part of a regional grouping than larger countries and those close to the core of the region.

In general, while there seems to be unanimity that RTA -generated effects stimulate FDI (or at least do not dampen them), economists are divided over whether the positive (or non-negative) effects are due to intra-regional FDI effects or extra-regional ones. Further, most studies indicate that the inclusion of investment provisions in RTAs plays a crucial role in promoting investment flows. Nevertheless, not all countries in the RTA are enriched to the same extent. Investment is expected to flow to those members of RTAs that have locational advantages (Jaumotte, 2004). Countries with relatively higher education and financial stability tend to attract a larger share of the FDI at the expense of other RTA members. Investment effects of RTAs therefore remain an empirical issue.

The present study adopts the first approach and focuses on initiatives in South Asia. It examines the magnitude and patterns of investment in the region, in particular intra-regional flows, against the backdrop of regional initiatives and discusses future prospects within the context of growing regional cooperation

3. Regional Cooperation in South Asia

South Asia is one of the economically most underdeveloped expanses of the world with five least developed countries viz. Afghanistan, Bangladesh, Bhutan, Maldives[7] and Nepal, two low income countries viz. India and Pakistan and one lower middle income country viz. Sri Lanka. This space is home to more than 20 per cent of the world's population including half the planet's poor. In recent years, however, it has emerged as one of the fastest- growing sections in Asia. According to ADB's Asian Development Outlook (2007) South Asia has averaged more than 7.5 per cent growth since 2003, enabling it to reduce poverty levels. India is the largest country accounting for almost 75 per cent of the population. As one of the world's top ten industrial powers, India has the most diversified regional industrial economy with the second largest pool of English-speaking, scientific and engineering personnel in the world (FICCI, 2003).

Most of these countries had adopted highly interventionist trade regimes in the initial phases of their growth. But this started to change in the late 1970s. From 1977, Sri Lanka began to liberalize gradually. It was followed by others in the 1980s. But this environment began opening up as a whole from the early 1990s (Jayasuriya and Weerakoon 2001, Sahoo 2006, RIS 2004, Dutta 2000). The process of economic liberalization manifested itself in considerable reduction in investment and trade barriers[8].

Alongside multilateral trade liberalization, these countries also activated the process of economic integration through regional, sub-regional and bilateral approaches. The South Asian countries with the exception of Afghanistan, formed the South Asian

[7] In terms of per capita income Maldives qualifies for the category of "lower middle income country". However, it is not shedding its "LDC" status for the fear of losing special benefits that it is enjoying due to that status.

[8] These reform efforts in individual countries are documented extensively in the literature and hence not discussed here at length. (See Acharya 2006 and Tendulkar and Bhavani for India, Atiqur Rehman and Tipur 2006 for Bangladesh, Hussain 2006 for Pakistan, Kelegama 2006 for Sri Lanka)

Association for Regional Cooperation (SAARC) in 1985 as a political consultation entity.

In December 1991, SAARC approved the establishment of an Inter-Governmental Group (IGG) at the Sixth Summit held in Colombo to formulate an agreement to establish a "SAARC Preferential Arrangement" (SAPTA) by 1997. Given the consensus within SAARC, the Agreement of SAPTA was signed on April 11, 1993, (much ahead of the schedule) and entered into force on December 7, 1995. SAPTA was envisaged primarily as the first step towards the transition to a South Asian Free Trade Area (SAFTA) leading subsequently towards a Customs Union, Common Market and Economic Union., The process of economic integration in South Asia gathered momentum with the implementation of the agreement

The *Agreement on South Asian Free Trade Area (SAFTA)* was signed on January 6, 2004, during the Twelfth SAARC Summit in Islamabad. The deal entered into force on January 1, 2006, and was formally launched on July 1, 2006. The special needs of the Least Developed Contracting States are recognized by adopting concrete preferential measures in their favour on a non-reciprocal basis. The arrangement is a traditional trade barriers reducing exercise. Its major objective is to eliminate obstacles to trade, both tariff and non-tariff, and facilitate the cross-border movement of goods between the territories of the Contracting States[9].

In addition to SAFTA, there have been three bilateral free trade agreements between South Asian countries : India- Bhutan, India-Sri Lanka, Pakistan-Sri Lanka; one sub regional preferential arrangement: Asia Pacific Trade Agreement[10] (India, Bangladesh, Sri Lanka, Philippines, Lao PDR and Korea) and seven trade agreements: India-Nepal, India-Bangladesh, India-Maldives, Bangladesh-Nepal, Bangladesh-Pakistan, Pakistan-Nepal and Sri Lanka-Nepal. Others are under process. A comprehensive Economic Partnership Agreement between India and Sri Lanka is under way. The Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation i.e. BIMSTEC (Bangladesh, Bhutan, India, Myanmar, Nepal, Sri Lanka and Thailand)-FTA aims to achieve its own free trade area by 2017. Finally, four RTAs are under negotiation: India-Pakistan, India-Bangladesh, Sri Lanka-Maldives and Pakistan-Bangladesh (Chaturvedi 2007). Table 3 provides an overview of sub regional/bilateral RTAs involving two or more South Asian countries.

A distinguishing feature of these agreements is that with the exception of BIMSTEC, all others are traditional RTAs which aim at reducing/ eliminating only trade barriers and exclude from their purview all other important issues such as services, competition, IPRs, government procurement and investment. Thus, regional cooperation in South Asia represents a shallow RTA, "old regionalism" only reducing or eliminating barriers to trade in commodities despite the fact that chronologically, it is a very recent phenomenon.

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[9] Under the Agreement, all non-LDC members would reduce their existing tariffs to 20 per cent (30per cent for LDCs) within a time frame of two years from the date of coming into force of the Agreement. The subsequent reduction to 0-5 per cent will be achieved within next five years' (eight years' for LDCs) period.

[10] Erstwhile Bangkok Agreement was initially signed in 1975.

Table 3 : Regional Trade Agreements in South Asia*

	Bangladesh	Bhutan	India	Maldives	Nepal	Pakistan
Bangladesh	1					
Bhutan	BIMSTEC[a]	1				
India	TA ** BIMSTEC[a] APTA	FTA BIMSTEC[a]	1			
Maldives			TA**	1		
Nepal	BINSTEC[a] TA**	BIMSTEC[a]	TA**. BIMSTEC[a]	-	1	
Pakistan	TA**	-	-	-	TA**	1
Sri Lanka	BIMSTEC[a] APTA	BIMSTEC[a]	FTA, BIMTEC[a] APTA	-	BIMSTEC[a], TA**	FTA

**These RTAs involve two or more South Asian countries; **: Trade Agreements, [a] Proposed*

The participation of South Asian countries in other forms of FDI undertakings such as BITs (Bilateral Investment Treaties) and DTTs (Double Tax Avoidance treaties) is also negligible. Though they are involved in 109 BITs, there are only four BITs in the region (Table 4). Double tax avoidance treaties are in force primarily among India, Pakistan, Bangladesh and Nepal. Bhutan and Maldives are not members of any such treaty.

Table 4: BITs and DTTs held by the South Asian countries

	BITs		DTTs	
	Total	*Intra Regional*	*Total*	*Intra Regional*
India	26	1 with Sri Lanka	65	4, Sri Lanka, Nepal, Bangladesh, Pakistan (Limited)
Pakistan	36	1 with Sri Lanka	51	4, India (Limited), Sri lanka Bangladesh, Nepal
Sri Lanka	26	2 with India and Pakistan	35	4, India, Sri Lanka , Pakistan, Nepal
Nepal	5		9	3, India, Sri lanka Pakistan, Bangladesh
Bangladesh	16		20	3, India, Sri Lanka , Pakistan, (Nepal under consideration)
Bhutan	0		0	
Maldives	0		0	
Total	109	4		

Source: Compiled from individual countries' relevant official websites

A "Draft Regional Agreement on Promotion and Protection of Investment" within the SAARC Region is under consideration of the member States and is meant to create conditions favourable for promoting and protecting investments in the region. Though initiatives for the Agreement were launched at a meeting held in New Delhi on 29-30

September 1997, the progress has been extremely slow[11]. South Asian region is thus viewed as one of the least integrated regions of the world representing old “regionalism”.

Does that mean cooperation in South Asia can have no impact on FDI in the region? There may be differing views on the success or failure of collaboration in South Asia. But theoretically, one cannot rule out the possibility that investment effects of trade provisions themselves may be substantial. Thus, even if all trade agreements in force are of the traditional variety, these can still have substantial impact on FDI.

Furthermore, the phenomenon of regionalism needs to be analysed not merely in terms of trade and investment but also with regard to other measures of cooperation and their implication for promoting peace and harmony, and building confidence in particular, in conflict-ridden regions such as South Asia (see also Khan and Larik 2007). The sub-continent is conflict-prone and vulnerable to continuous political tension. Strains tend to recur periodically and have not allowed an atmosphere of trust to transpire. Any initiative by these countries can prove instrumental in resolving conflict and promoting harmony. This in turn can lead to a better investment climate. Evidence suggests that regional integration in the form of economic cooperation and political harmony are mutually-reinforcing. ASEAN + 3, APEC and ASEM in Asia have led to improved relations between East Asian countries. The success of EU has demonstrated that regionalism can be valuable in overcoming historical animosities and ensuring stability. Mexico has a long history of distrust and resentment of the U.S. But NAFTA has had a dramatic impact on the political relationship between the United States and Mexico.

Finally, several initiatives have been taken by SAARC outside trade agreements, which are likely to have a deepening effect on regional cooperation and affect trade and investment flows positively. These are as under.

The SAARC Chamber of Commerce and Industry (SCCI): It was set up in 1992 as the first recognized regional Apex Body. SCCI brings together under one umbrella the national chambers of commerce and industry of the member States and is actively engaged in the promotion of trade and the interaction of the business community within the SAARC region.

SAARC Trade Fairs: These exhibitions have become a regular feature since 1996 when the first Trade Fair was held in India. SAARC Trade Fairs provide a common platform to the business and trading community for showcasing their products.

SAARC Finance: SAARCFINANCE is a formal body comprising of governors of SAARC Central Banks which reports to the organization’s Council of Ministers. Its objective is to strengthen the individual financial systems of the member countries through the expansion of their institutional capacity, surveillance mechanism and consultative capability on and coordination of macro-economic policies.

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[11] SAARC Secretary-General has recently announced that the SAARC is engaged in the early finalization of the agreement on promotion and protection of investments (The Hindu, Feb 18, 2007).

Networking with international agencies: A Framework Cooperation Agreement was signed between SAARC and ESCAP (Economic and Social Commission for Asia and the Pacific) *(February 1994)* to provide for cooperation on developmental issues through joint studies, workshops and seminars and exchange of information and documentation in poverty alleviation, human resource development, trade promotion, foreign direct investment, environmental protection, prevention of drug trafficking, infrastructure development and so on.

South Asian Development Fund: It is proposed to set up a South Asian Development Fund (SADF). The SDF will serve as an umbrella financial institution for all SAARC projects and programmes. It has the potential to implement cross-border collaborative projects, including those on improving infrastructure and the energy sector.

SAARC University: The first South Asian University will be set up in Delhi and begin educational activities by July 2009.

Governmental initiative on increasing regional cooperation is carried forward by a group of international agencies[12]. These organizations have supported the formation of the "South Asian Federation of Exchanges" (SAFE) in January 2000. Its members comprise 13 stock exchanges in Bangladesh, Bhutan, India, Mauritius, Nepal, Pakistan and Sri Lanka. The convener bourse, the Chittagong Stock Exchange, acts as the SAFE secretariat. The objectives are two-fold: the strengthening of stock exchange listing regulations in individual SAFE member countries and facilitation of the progress towards harmonization of listing regulations to develop capital markets

These project is also likely to have substantial impact on capital and human resources movement and, in turn, on FDI inflows. In what follows, we analyse the trends and patterns of FDI in the region.

4. Foreign Investment Flows in SAARC: The Current Status

4.1 Overall FDI Trends

FDI Inflows

Until recently, most countries in South Asia were not seen by international investors as attractive investment destinations. In any case, these countries themselves had a restrictive attitude towards foreign investments. FDI flows were therefore quite minimal (Table 5). In the early 1990s, most of them began opening up their economies. This was also the period when schemes for regional cooperation were accelerated. FDI flows to the region started to pick up in the 1990s and have gathered further momentum in the past few years. Thus, FDI to South Asia increased from an

[12] The Financial Sector Reform and Strengthening Initiative (FIRST) a $65 million, multi-donor programme is supported by the World Bank, the International Monetary Fund (IMF), and five bilateral donors: the Department for International Development of the United Kingdom, the Canadian International Development Agency, the State Secretariat for Economic Affairs of Switzerland, the Ministry of Foreign Affairs of the Netherlands and the Swedish International Development Cooperation Agency.

average of $2.5 billion per year during 1990-2000 to an average of $13.3 billion per year over 2004-06, an around six-fold increase (UNCTAD 2007)[13]. All the countries of the region (with the only exception of Bhutan and Nepal) have gained in terms of FDI flows. In fact, they grew faster than either the rest of the developing world or the the world at large. The ratio of FDI inflows to capital formation also doubled from 2.3 during 1990-2000 to 9.3 by 2006.

Table 5: Overall FDI Trends in South Asia ($US mn)

	1980-85	**1990-2000**	**2003**	**2004**	**2005**	**2006**
Bangladesh	-0.1	190.0 (2.5)	350.0 (2.9)	460.43 (3.0)	692.0 (4.9)	625.0 (3.9)
Bhutan	NA	2.0 (0.1)	1.06 (0.3)	3.0 (0.1)	9.0 (1.4)	6.0 (0.9)
India	62	1705.0 (3.0)	4585.0 (3.4)	5771 (3.2)	6676.0 (3.6)	16881.0 (8.7)
Nepal	0.2	11 (0.6)	14.8 (1.3)		2.0 (0.2)	-7.0 (-0.4)
Pakistan	75	463.0 (7.2)	534.0 (4.2)	1118.0 (7.5)	2201.0 (13.0)	4273.0 (24.1)
Sri Lanka	42	159.0 (5.6)	228.7 (5.7)	233.0 (4.7)	272.0 (4.2)	480.0 (6.2)
Maldives	-.03	9.0 (7.6)	14.0 (7.2)	15.0 (5.4)	9.0 (4.8)	14.0 (6.4)
South Asia	178.8	2539.0 (2.3)	5727.6 (3.5)	7601 (3.4)	9866.0 (4.3)	22274.0 (9.3)
Asia	5043	76616.0 (8.0)	110489.0 (7.7)	169999.0 (9.4)	208744.0 (11.1)	259434 (12.9)
Developing Countries	12634	134670.0 (8.9)	175138.0 (9.3)	283030.0 (10.7)	314316.0 (12.8)	379070 (13.8)
World	49813	495391.0 (7.6)	557869.0 (7.3)	742143.0 (7.7)	945795.0 (9.4)	1305852 (12.6)

Note : Parentheses show the ratio of FDI to gross capital formation
Source : UNCTAD (2007)

Yet, despite the big jump in FDI inflows, the share of the region in global FDI flows remains negligibly small. While the average annual share of developing countries in global FDI inflows during 2004-06 was over 32 per cent, South Asia accounted for only 1.7 per cent of the global FDI inflows. In addition, for none of the countries (except Pakistan) was the average ratio of FDI inflows to gross fixed capital formation in 2004-06 higher than for developing countries as a whole.

[13] It is instructive to note that FDI statistics of South Asian countries as provided in earlier issues of World Investment Reports are not comparable with the actual statistics provided by the country specific sources.

Table 6 shows that within these overall trends, individual countries performed highly unevenly. India alone contributed three-fourths of total FDI to South Asia in 2006. Pakistan, Bangladesh and Sri Lanka accounted for almost 24 per cent of the investment. The share of Nepal, Bhutan and Maldives had been negligible. In relative terms, however, only Pakistan and Bangladesh improved their share in the SAARC FDI. All other countries (including India) witnessed a decline in their allocation to regional FDI inflows. In 2007-08, however, India witnessed a phenomenal increase in FDI which exploded to $25 billion, overwhelming the performance of other countries in the region. Pakistan registered a decline of 14.1 per cent during this period.

Table 6: Share of Individual Countries in SAARC FDI Inflows in Selected Years (1990-2005)

	1990-2000	**2003**	**2004**	**2005**	**2006**
Share in South Asia (%)					
Bangladesh	7.48	6.11	6.06	7.01	2.81
Bhutan	0.08	0.02	0.04	0.09	0.03
India	67.15	80.05	75.92	67.67	75.79
Nepal	0.43	0.26	0.03	-0.07	0.00
Pakistan	18.24	9.32	14.71	22.31	19.18
Sri Lanka	6.26	3.99	3.07	2.76	2.15
Maldives	0.35	0.24	0.20	0.09	0.06
Share of South Asia in (%)					
Asia	3.31	5.18	4.47	4.73	8.59
Developing countries	1.89	3.27	2.69	3.14	5.88
World	0.51	1.03	1.02	1.04	1.71

Source : UNCTAD (2007)

FDI Outflows

Outward investment from developing countries has gone up significantly since 2004 (UNCTAD 2007). It increased sharply from $35 bn to $113 bn in 2004 and then touched the peak of $174 bn in 2006. It was primarily due to a massive increase in FDI outflows from Asia (table 7). Total outflows from South Asia also increased and stood at $9.8 billion in 2006, compared with $124 million in 1990-2000. Its share in Asia's FDI outflows swelled from 2.6 per cent in 2004 to over 8 per cent in 2006. But India alone represented over 95 per cent of total outflows. For all other countries these movements were insignificant and did not surpass even the $50 million mark.

Table 7 : Trends in FDI outflows from South Asia ($ mn)

	1990-2000	2003	2004	2005	2006
Bangladesh	4	6	6	2	8
Bhutan	Nil	Nil	Nil	Nil	Nil
India	121	1325	2179	2495	9676
Nepal	Nil	Nil	Nil	Nil	Nil
Pakistan	5	19	56	44	107
Sri Lanka	7	27	6	38	29
Maldives	1	Nil	Nil	Nil	Nil
South Asia	124	1378	2247	2579	9820
Share of India in South Asia (%)	97.58	96.15	96.97	96.74	98.53
Share of South Asia in Asia (%)	0.37	7.25	2.57	3.32	8.39
Share of Asia in Developing countries (%)	66.00	53.40	74.54	67.10	67.13
Share of Developing countries in world (%)	6.30	13.90	13.37	13.84	14.34

Source: UNCTAD (2007)

In sum, since 2004, FDI flows into South Asia have been increasing more rapidly than in the developing world. Within the region, however, only India, Pakistan and Bangladesh have succeeded in stimulating FDI inflows; other countries do not seem to benefit from the current growth of the phenomenon. While one cannot rule out the possibility that regional programmes along with multilateral reforms might have had a positive impact on FDI flows, clearly the advantages were not equally distributed. These initiatives, as stated above, are no substitute for the congeniality of country-specific investment climates.

4.2 Patterns of FDI by Source Country

The sources of FDI are highly diversified in most SAARC countries. Though the dominant tendency is still for FDI to originate in developed countries, the share of developing countries is also fairly significant. The rationale behind FDI from developed country sources is directly related to the industrial sophistication of the host country. Thus India, which is industrially the most advanced country in the region, , attracts most of its FDI inflows from the developed world. Notwithstanding the fact that the traditional OECD countries contributed only 27 per cent of total FDI during 2006 and 2007, investment which is routed through Mauritius and Singapore and accounts for 49 per cent of FDI inflows into India, also originates primarily in developed countries. This is due to tax benefits available to investors as a result of trade and investment agreements with these countries. Other developing countries accounted for only six per cent of total FDI inflows into India in 2006 and 2007. In Sri Lanka, which is a middle income country, the major investors are from the US, UK and Australia. The share of the non-OECD investment is relatively smaller for Pakistan (60.5 per cent in 2006-8) and Bangladesh (51.2 per cent in 2005-6). Of the 50 countries that have their commercial presence in Nepal (up to 2005-06), 33 are developing countries, accounting for 66 per cent of FDI in the country. Very few FDI projects have been commissioned in Bhutan. UNESCAP (2006) provides information on five FDI projects in Bhutan, two of which are in collaboration with Singapore while one each is a joint venture with India and Japan. The remaining project is a bank (Bhutan National Bank) in which ADB holds 10 per cent equity share.

Locational proximity is an important determinant of investment decisions for developing country firms. Fifty-six per cent of the non-OECD investment in Pakistan during the past two years originated from neighbouring West Asia; the share of South, East and South East Asia was 34 per cent. In Bangladesh, closely-situated South and South East Asian countries are the major developing country investors. They accounted for more than 24 per cent of the total FDI in the past two years. Egypt and UAE have recently emerged as major investors in the country. In Nepal, India and China alone accounted for 60 per cent of investment during 2005-7. Other nearby sources, viz. Taiwan, Singapore, South Korea, are also important contributors to the country. Sri Lanka has a large commercial presence of firms from close- at- hand Singapore, Malaysia, South Korea, Hong Kong and India.

Table 8 : Share of 5 top investors in Individual South Asian Countries (%)

Host country	Year	Top 5 countries	Share of top 5 countries	Share of traditional OECD countries (%)	No. of identified source countries
India	2006 and 2007	Mauritius, UK, Singapore, US, NRI	66.1	27.0	100
Bangladesh	2005 and 2006	US, UK, Egypt, UAE, Norway	68	51.2	31
Pakistan	2006-7 and 2007-8	US,UAE*, UK, Netherlands, Switzerland	64.1	60.5	33
Nepal	2005-08	India, China, S.Korea, Japan, Canada,	67.0	22	25
Sri Lanka	2002	Malaysia, Singapore, UK, India, USA	62	NA	NA

Sources: BOI: Pakistan and Bangladesh; DOI: Nepal; SIA: India; ESCAP (2003): Sri Lanka.

4.3 Intra Regional FDI Flows

If geographical proximity is important for developing country firms then one should expect large intra regional FDI inflows in SAARC countries, especially after the regional initiatives took off. Table 9 indicates that intra regional inflows have increased in the post- 2000 period but, with a few exceptions, they remain rather small. Regional FDI flows into the three largest recipients of FDI viz. India, Bangladesh and Pakistan, are negligible. However, Nepal, and, since 2002, Sri Lanka, has been attracting substantial FDI from India.

Table 9: Intra Regional FDI Inflows (% of country total)

	India		Bangladesh		Pakistan		Nepal		***Sri Lanka***
	2001-3	2006-7	1995-6	2005-6	2001-5	2006-8	Upto 2006	2006-07	*2005*
India	-	-	0.62	0.54	.001	.002	40.71	46.6	*6.2*
Bangladesh	-	-	-	-	.05	.10	0.75	-	*.18**
Pakistan	-	-	1.4	1.87		-	0.47	-	*.6**
Nepal	-	-	-		-	-	-	-	-
Sri Lanka	.009	.014	0.23	.41	-	-	0.13	-	
Bhutan	-	-	0.005		-	-	.01	-	-
Maldives	.008	.009	0		-	-	0.0	-	*Na*
Share of South ASIA	*.017*	*.023*	*2.25*	*2.82*	*.06*	*.102*	*41.8*	*46.6*	*7.0*

** pertain to the year 2000. It's not expected to have changed*
Sources: BOI: Pakistan and Bangladesh, SIA: India; DOI: Nepal; UNESCAP 2006: Bhutan

It is generally expected that because Third World companies are relatively small they will invest in labour-intensive small businesses. If that is indeed the case, it is possible that the magnitude of FDI does not reflect the true significance of a developing country FDI. Therefore, analysis of intra-regional investment on the basis of the number of projects may be useful. Locomonitor, which tracks year-wise FDI projects by country since 2002, also shows that India is emerging as a major investor within the region. Table 10 shows the five top investors in each of the SAARC countries (for which information is available) over the past 4 years. It suggests that India has figured as one of the top investors in all FDI- receiving South Asian countries in terms of the number of projects. Thus a beginning has been made in the direction of investment relations.

Table 10 : Share of top 5 investors in South Asia since 2002-06 (No. of projects)

	Sri Lanka	Pakistan	Bangladesh	India
India	19 (40%)	9 (6%)	14 (27%)	
US	8 (17%)	26(18%)	8 (16%)	1267 (46%)
UK	3(6%)		4 (8%)	300(11%)
Germany	2(6%)	9(6%)	7 (14%)	195(7%)
Japan				142 (5%)
France				102(4%)
Malaysia	3 (4%)			
China		12(9%)		
UAE		18(13%)		
Total	54	1500	51	3051

Source: Loco monitor website

In what follows, we provide a descriptive analysis of intra-regional FDI inflows and outflows of SAARC countries.

India

Table 11 is based on the information provided by the Secretariat of foreign investment approvals and actual inflows. It is interesting to note that Sri Lanka has emerged as the largest investor in India from the region. Sri Lanka accounted for 84 per cent of total projects approved over the period 1998-00. After the India-Sri Lanka FTA came into force in 2000, flows from Sri Lanka also increased. Of the total 31 projects cleared during 2002-2006, 28 were from that country. Other investors from the region viz. Bangladesh (6), Maldives (4) and Nepal (1), were left far behind despite SAPTA and then SAFTA. Recently, a Sri Lankan company has set up its own SEZ (Brandix) in the country in the textile sector.

Sectorally, intra-regional FDI into India is dominated by trade and distribution. One-third of total FDI proposals from the regional countries between 1998 and 2006 was in this area. This was followed by travel and transport and IT services. FDI in manufacturing was in low tech labour- intensive sectors such as food, textiles and leather.

Table 11 : Source country-wise distribution of FDI projects from SAARC region in India

	SAARC countries	Sri Lanka	Bangladesh	Maldives	Nepal
1998-00	17	10	4	3	0
2001	7	7			0
2002	4	3	1		0
2003	3	3			0
2005	11	9	1	1	0
2006	7	7	0	0	0
2007	6	6	0	0	0

Source: Newsletters, various issues, Department of industrial Promotion and Policy

Table 12 shows the magnitude and patterns of outward investment that originated in India in terms of approvals. It suggests that South Asia accounts for only 1.5 per cent of total Indian outbound investment. From 2003, more than 80 per cent of Indian investment in the region flowed to Sri Lanka. Indian investment in Nepal was also significant but declined after 2002.

Table 12 : Country-wise distribution of India's outward FDI in the SAARC Region (US$ Mn)

	Total Outward	South Asia	Bhutan	BD	Maldives	Nepal	Pakistan	Sri Lanka
1996-02	6353.6	2.6	0.0	9.1	12.8	40.7	0.0	37.4
2002-03	1334.3	1.2	0.0	7.4	0.0	35.6	15.7	41.3
2003-04	1191.2	4.5	0.0	7.6	0.0	9.9	0.0	82.6
2004-05	2262.9	0.7	0.0	11.1	0.0	24.9	0.0	64.1
2005-06	2136.3	1.0	0.0	5.9	5.4	3.9	0.0	84.9
2006-07	5370.7	0.1	0.9	11.1	0.9	2.1	0.0	85.0
Total	18653.7	1.5	1.8	8.4	7.9	29.5	0.9	51.4

Source: Computed from the Ministry of Finance Database

Sri Lanka

India is one of the largest overall foreign direct investors in Sri Lanka (following Singapore, UK and Australia). Although historically inflows have been low, there has been a dramatic increase after the India-Sri Lanka FTA came into effect. In the year 2000, India's share was just about two per cent (Jayasuriya and Weerakoon 2001) in Sri Lankan FDI stocks and the country did not even figure among the top 10 investors (Kelegama and Mukherjee 2007). Within five years it became the fourth-largest The year 2006 witnessed a cumulative total investment of USD 170 mn against the cumulative total of USD 94 mn in 2000, registering India as one of the major foreign direct investment sources of Sri Lanka[14]. Seeing the potential for investments from India, the Sri Lankan Board of Investments opened its first overseas branch in Bangalore on May 23, 2005.

The principal sectors which have attracted Indian investment are steel, cement, rubber products, tourism, computer software, IT-training and other professional services. Some of the most visible Indian investments are Lanka Indian Oil Corporation, Tatas (Taj Hotels, VSNL, Watawala tea plantations) Apollo Hospitals, LIC , L & T (now Aditya Birla Group), Ambujas, Rediffusion, Ceat, Nicholas Piramal, Jet Airways, Sahara, Indian Airlines and Ashok Leyland. Indian Human Resources and Education Companies like ICFAI have also started entering the Sri Lankan market. Indian banks like ICICI, UTI Bank, and an educational establishment like the Manipal Medical Institute, are in the pipeline. Over the past three years, leading Indian companies such as Gujarat Ambuja, Asian Paints and Larsen and Toubro have committed substantial investments, while existing companies_--CEAT and Taj Hotels, for example-- have expanded their operations. A further impetus to bilateral economic relations is expected following the implementation of the Indo-Sri Lanka comprehensive economic agreement.

[14] Speech by the DHC on India Sri Lanka Trade Relations

Clearly, the India- Sri Lanka FTA has been a significant success in terms of investment flows. It has promoted intra-regional investment in both the countries. Sri Lanka has another FTA in force with Pakistan (PSLFTA). It was signed in July 2002 and came into operation on June 12, 2005. Much is expected of the FTA. Currently, trade between India and Pakistan takes place mostly via Singapore or Dubai. Sri Lanka can promote Indo-Pakistan trade by encouraging Pakistani investors to open operations in Sri Lanka in order to trade with India using the ISLBFTA and vice versa and can gradually acquire the hub status in South Asia . This can promote efficiency in seeking investment in Sri Lanka. However, though there have been several inquiries, no significant progress has been made in this direction till date.

Pakistan

Pakistan has opened all its sectors for FDI. However, response is still negligible. Of all the companies in Pakistan since 2002, data is tracked by Locomonitor for 1500 foreign companies that have initiated investment projects since 2002. Of the top five multinationals approved, two are Indian: Tata Consultancy and UTI. They will initiate seven projects in Pakistan. Dabur India will soon acquire a foothold by setting up a manufacturing joint venture with a Pakistani firm. Ayurvedic products will be the fulcrum of their joint ventures. But progress seems slow. These countries are not even signatories of BITs.

Bangladesh's investment in Pakistan has increased in the past two years. Both countries have been signing MOUs for promoting joint ventures in tourism, establishment of beach resorts, heritage and amusement parks, hotels, customs and visa facilitation and training in hotel management and hospitality services. Both countries have also formed Joint Economic Commission (JEC), a Joint Working Group and Joint Business Councils. They have formed a Pakistan-Bangladesh Joint Investment Company to finance joint ventures in several key areas such as textiles, pharmaceuticals, readymade garments, IT, auto industry and agriculture to enhance bilateral trade. A free trade agreement (FTA) is in progress to enhance mutual trade and cash in on the economic growth in both countries.

Sri Lanka –Pakistan FTA has recently come into operation and efforts are being made by the respective Boards of Investment to persuade investors through seminars, conferences and research to set up ventures across borders. However, forward movement has not been registered in terms of FDI.

Bangladesh

On an average, regional FDI accounted for 2.25 per cent of total FDI flows into Bangladesh during the period 1995-2006 (Bhattacharya 2007). However, during the past two years it was 2.82 per cent, primarily owing to increased FDI from Pakistan. Investment from Sri Lanka has also increased somewhat. Sri Lanka has invested in the service sector while India's investors are in the chemical and engineering segments. In terms of the number of projects, India is one of the top five that have invested since 2002. State Bank of India is among the leading five companies that have invested here. Some Indian companies in Bangladesh include Asian paints, Marico, ACI Godrej-agrovet and Neelkamal Padma Plastics private limited.

In the export-oriented sector also, the share of intra-regional investment was only 1.35 per cent as on January 2007 but in the agro sector it accounts for more than 73 per cent of investment. Of the cumulative South Asian investments in the EPZs, 53 per cent has been made by India and 43 per cent by Pakistan (Bhattacharya 2007).

Nepal

The Nepalese Department of Industries' statistics reports that as of end 2006 there were a total of 1067 foreign projects. Of them 362 have originated from the region itself (over one-third). These projects accounted for more than 47 per cent of overall employment in foreign companies. India alone has 331 projects approved in the country. South Asian companies have invested in construction, manufacturing, tourism and services. While investment from India is dominated by manufacturing, Sri Lanka has primarily invested in the service sector. FDI from Pakistan, Bangladesh and Bhutan are highly diversified into manufacturing, services and tourism. In the manufacturing sector, textiles, chemicals, food and beverages and fabricated metals attract the largest FDI in the country.

Bhutan

Only five FDI projects have been commissioned in Bhutan. Of them two have been set up by Singapore (tourism), one by India (finance) and one by Japan (metal based manufacturing). The fifth project is equity held by ADB in the National Bank. It was expected that FDI inflows would grow after the introduction of the FDI policy in 2002 but Bhutan's external financing continues to rely heavily on foreign aid, grants and loans.

Maldives

Several foreign companies and individuals have invested in the Maldives but it has not been possible to obtain all the details about these investments since government authorities have not been willing to disclose such information.

In sum, the above analysis suggests that new investment opportunities are emerging for firms in the region and that intra-regional FDI flows have been increasing slowly in absolute terms. But neither multilateral liberalization nor regional integration succeeded in making a significant impact on intra-regional FDI. However, Sri Lanka-India FTA appears to have had a substantial impact on investment flows. Efforts are now being made to promote other bilateral FTAs. Further, Indian firms have been emerging as important investors in the region, which was predictable. Firms from more advanced developing countries have firm specific advantages which they can 'cash in' on in other such economies if investment barriers are lowered. Less developed countries, on the other hand, attract investors to grasp the new opportunities emerging there. These patterns are somewhat visible but countries in this region have not exploited the potential of intra-regional FDI inflows. A part of this could be owing to shallow regional assimilation. Empirical studies have shown that investment provisions have a greater impact on FDI flows than the trade related conditions.

Many believe that any direct increase in intra regional trade and investment will be limited despite deeper integration because South Asian countries share some basic similarities (low income, relative labour abundance and comparative advantage in similar commodities) which reduce the potential for trade (Kemal 2001) and investment. The argument is that even after SAPTA came into force in 1995, intra-SAARC trade has remained a small fraction (4.5 per cent) of total trade. Intra-EU trade is 55 per cent, intra-NAFTA trade stands at 61 per cent and intra-ASEAN trade is 25 per cent of its total. Others show that there is considerable scope for intra regional economic activity (see, Taneja 2001, 2004, 2006 Mohanty 2003). Most analyses focus on trade, but there is need to assess the future prospects of FDI flows also.

In what follows, we focus on the future of FDI inflows, in particular, the intra regional variety. We argue that the deepening of regional cooperation is vital for stimulating FDI inflows and outflows.

5. Intra-regional FDI Flows: Future Prospects

There are vast differences in terms of the technological sophistication of these economies. The Global Competitiveness Report 2007-8 reports that India leads the group and is ranked 48th followed by Sri Lanka (70), Pakistan (92), Bangladesh (107), and Nepal (114). In terms of the “basic requirement factors” (macro economic stability, institutions, infrastructure) the countries are closely placed. Dissimilarities increase in the category of “efficiency enhancing factors”. In the third category of considerations that represent technological readiness and innovative capabilities, the gaps seem to be huge. These dissimilitudes create strong possibilities for domestic market-seeking as well as efficiency-seeking FDI as has been suggested above. This also shows that there are opportunities for production- sharing that allow creation of global value chains within the region and entry of firms into existing networks at different stages of manufacture. Firms in relatively advanced countries can trace subsidiaries in contiguous locations for low value-added activities. Domestic market seeking joint ventures between developing countries can create big opportunities for technology spillover among local enterprises.

Structural contrasts also provide enormous scope for FDI in the service sector. Mukherjee (2005) shows that revealed comparative advantage of South Asian countries in services differ across sectors. While Pakistan and Sri Lanka have comparative advantage in transport services, Maldives has this benefit in travel and tourism and India in IT and IT-enabled services. There is thus scope for cooperation in the service sector as well. Moreover, production sharing is not limited to trade in goods as service functions can also be fragmented and dispersed to take advantage of marginal differences in costs, resources, logistics and markets. There is scope of service MNCs in the region and creation and extension of global value chains. There are thus enormous openings for vertical FDI by firms both from within the partner countries and from outside the RTA. India has become the leading destinations for the outsourcing of BPO and IT services. Outsourcing to India has evolved to more sophisticated and skills-based services including software development, research and development (R&D), financial portfolio analysis, patent

Table 13: Competitiveness Index of South Asian Countries

	Rank				Index of scores (India =100)			
	GCI rank	*basic requirement*	*efficiency enhances*	*innovativeness*	*GCI score index*	*basic requirement*	*efficiency enhances*	*Innovativeness*
India	48	74	31	26	100	100	100	100
Sri Lanka	70	85	73	47	92.1	97.2	84.1	89.9
Pakistan	92	98	81	78	87.1	91.0	81.9	80.3
B.desh	107	111	91	111	82	85.3	78.5	68.6
Nepal	114	115	115	120	78.1	83.9	70.4	66.3

Source: GCR, 2007-08

writing and product design and development. There are therefore opportunities to outsource low-to-mid skill areas like call centres and routine data-crunching tasks to less advanced countries. Press reports indicate that Indian firms are assisting the call centre industry in Pakistan.

Regional diversities are reflected in national competitive advantages and mirrored in their export basket. India's exports are highly diversified and include durable consumer goods, intermediate products and certain electrical and electronics machinery that is competitive in South Asian markets given the level of sophistication of these markets. Other economies in the region are smaller and are specialized (in varying degrees) in the production of labour intensive products, especially textiles, garments, leather goods, seafood and agricultural products. There is huge latitude for industrial diversification and cooperation among these economies. As suggested above, the process of modernization is already under way *albeit* slowly. Intra regional FDI itself can play a vital role in bringing these economies uptodate.

Several companies have gradually accumulated technological capability, established firm leads and are looking for the chance to expand in similar markets. According to the investment development path (IDP) approach, contributed by Dunning (1979), these companies tend to invest initially in resource and market-seeking activities in neighbouring or other developing countries, and then expand their presence worldwide (Dunning, 1979, 1993; Narula, 1995). Cultural and ethnic ties, geographical proximity and small markets in individual countries are some of the major factors that operate as stimulants of this type of investment. TNCs from the South often have lower overhead costs, and they frequently employ local managers. They thus possess greater expertise in dealing with the economic and political conditions of a host developing country than TNCs from developed countries (Wells, 1983). Furthermore, TNCs from developing countries are relatively small and use comparatively more labour-intensive technologies and have higher chances of creating technology spillovers. Most FDI industries in Nepal, for instance, concentrate on small and medium-scale enterprises (SMEs). FDI in Nepal is much more the handiwork of individual foreign investors than corporate business enterprises. Almost 65 per cent of foreign enterprises had been registered in Nepal as small-scale ventures. Indian investments are mostly labour-intensive, while those of the USA generally more capital-intensive**.** The Department of Industries, Nepal statistics (2006), shows that employment per Rs one million investment was 4.8 for India, 34.1 for Bangladesh and 19 for Pakistan in 2005-06. For the UK and China, which were the other largest investors, it was two and three respectively. Thus the benefits of regional FDI are highly beneficial in terms of employment generation[15]. Accordingly, TNCs from the South, because of the nature of their comparative advantages, tend to invest in countries that are at a similar or lower level of development than their home countries (Wells, 1983). Evidence suggests that India -Sri Lanka FTA has led to

[15] A careful analysis of FDI patterns in the region (based on the reports published by Pakistan, BOI, Bangladesh BOI and India SIA) reveals that in general, investments from the developing countries are manufacturing oriented. On the other hand, developed countries' investments are mostly service-oriented and are concentrated in highly capital intensive sectors such as power, energy and telecommunication. Developing country firms are also investing in the service sector but they focus on low technology and low scale intensive IT and IT enabled professional, management and financial services.

Table 14: Composition of Export baskets of South Asian Countries at two digit level: 2004 (% share in total exports)

In		**SL**		**Pak**		**Nepal**		**Bangladesh**		**Maldives**	
Mineral fuels	15.0	Textile Pdts	48.7	Textile products	39.8	Textile products	39.9	Textile products	86.3	Fish Stuff	97.5
Gems	12.7	Coffee, tea and spices	9.7	Cotton	21.3	Fats and oils	6.9	Fish	4.2	**TOTAL**	**97.5**
organic chemicals	4.5	Rubber and articles	8.8	Cereals	6.8	Plastics	4.4	Leather	3.0		
iron & steel	4.4	Gems	5.7	Leather	5.9	chemical products	6.6	Headgear	1.1		
Tex. products	4.2	Fish	2.7	Mineral fuels etc	5.0	Iron and steel	3.2	Fertilizers	0.6		
Engineering	4.0	Elec., elect. equipment	2.4	Toys, sports goods	1.8	Beverages,	2.8	**TOTAL**	**95.2**		
ores etc	3.9	Engineering	1.9	**TOTAL**	**80.5**	**TOTAL**	**63.9**				
Elec., elect. equipment	3.3	Animal, vegetable oils	1.5								
cotton	3.1	Metals	1.4								
vehicles	3.0	**TOTAL**	**82.9**								
TOTAL	**58.1**										

Source : ITC

Table 15 : An Overview of FDI Policies in South Asia

	Bangladesh	India	Nepal	Pakistan	Sri Lanka	Bhutan	Maldives
Pre-entry Treatment							
Sectoral ban on FDI	Private ownership restricted in 4 sectors	9 broad sectors		Alchohol		Positive list of sectors	
Caps of foreign ownership	None	Ownership cap on 16 sectors	FDI prohibited in 23 sectors.	100% in all	A negative list of sectors	Max 70% equity allowed.	Investment>5 million can be wholly owned.
Screening	No screening except in telecom, power and mineral	Screening for FDI in specified sectors	Approval from department of industries	No screening except in 5 mfg sectors[16]	Strict screening by BOI	FDI committee which meets once in 3 months	Mandatory Screening if foreign equity >51% Conditional screening if it is <51%
Minimum Capital requirement	None	None	None	Ag: $0.3mn, Infra : $0.3mn, IT and Telecom: $0.15 mn.	None	Mfg. $1Mn Services: $0.5 Mn	None
Location	None	None	None	None	None	None	None

[16] Arms and ammunitions -High Explosives. -Radioactive substances -Security Printing, Currency and Mint

	Bangladesh	**India**	**Nepal**	**Pakistan**	**Sri Lanka**	**Bhutan**	**Maldives**
Post entry treatment							
Employment						Restricted	No*[17]
Performance requirement	none	In the small scale sector	None	None	None		Use of local content encouraged
Technology imports	None	None	Sub to approval	Limits in agriculture and service	None	Sub. To approvals	NO*
Restrictions on repatriation of capital and profits.	None	None	Sub. To approvals	None	None	Sub to restrictions	NO*
Tax incentives	Tax incentives on expatriate incomes.	Non discriminatory	Non discriminatory	50% on plant and machinery and depreciation	Non discriminatory	Non discriminatory incentives	Foreign investors have to pay royalty to the government

Sources : BOI : Bangladesh, Pakistan, Sri Lanka; Royal Monetary Authority : Bhutan; DOI : Nepal and SIA : India; FISB: Maldives

[17] Rules and conditions under which investors may operate, including the approved business activities, lease terms for land, the royalty payments and fees due to the government, and investment duration are governed by contracts signed between the government and investors.

substantial expansion of investment in both the countries from the partner country (JSG, 2003, RIS, 2004). Historically, investment relations have remained one-way flows of FDI from India to Sri Lanka (JSG 2003). Not only has bilateral investment been increasing, sectoral composition has also been subject to diversification.

The inclusion of investment provisions would further boost the mutual benefits from economic integration. Like many other emerging market economies, South Asian countries have also taken a number of steps to liberalize FDI regimes by augmenting the automatic approval route, lowering sectoral caps, simplifying exchange controls and intensifying investment promotion. Table 13 provides an overview of FDI policies in terms of pre-entry and post-entry treatment of foreign investors. Pakistan seems to be the most liberal FDI regime followed by Bangladesh, India, Sri Lanka, Maldives and Bhutan, in that order. Although most countries ensure post-entry national treatment, pre-entry restrictions are quite high. These barriers can be addressed at the regional level without compromising policy space and investment liberalization may be implemented effectively.

Unrestricted access to neighbouring markets will allow investors to expand their capacities, restructure their businesses and diversify their production facilities. Greater regional cooperation in FDI will not only promote intra-regional investment but also extra-regional investment by stimulating efficiency and growth, and building investor-confidence. This, in turn, has the capacity to transform the dynamic comparative advantages of these economies.

Most countries have adopted an "FDI targeting approach". In that context they are aiming at FDI in certain priority sectors. Table 16 provides a country-wise list of these segments. It clearly shows that most countries are marking investment in light and labour intensive industries where regional firms have developed competitive advantages.

Table 16: Priority Sectors for FDI in South Asian Countries

Pakistan	Priority industries: tourism, housing, engineering, chemicals and construction. "Value added export industries": manufacturing categories such as garments, bed linens, surgical instruments, and sporting goods. High-Tech and Information Technology industries: chip manufacturing, software development and precision equipment manufacturing.
Bangladesh	Textiles, Electronics, IT, natural gas based industries, frozen foods, leather, Ceramics, Light engineering and agro based
Nepal	Medicinal and aromatic plants, agro based (mushroom., spices, vegetables, fruits), Dairy, Tea, Sericulture, Hydro power, leather, Poultry and textiles
Sri Lanka	Electronics, light engineering, Textiles, Rubber, mineral and processing, Tourism, IT, Gems and Jewellery, Health care and Pharmaceuticals, ceramics, services
Bhutan	Hydro power, agro processing, tourism, medicinal plants,
Maldives	Marine based industries, Tourism, Infrastructure and air and sea transport

Source: Compiled from the FDI promotion agency of each country

Deeper regional cooperation which involves cooperation in investment and economic integration will thus promote FDI flows by overcoming regional apprehensions and constraints. This will pave the way for the most efficient use of the region's resources through additional economies of scale, value addition, employment and diffusion of technology. It's important to re-emphasize that this trend promotes not only intra FDI flows but also extra regional FDI.

The literature, however, suggests that the effects of regional integration on FDI are more pronounced when they coincide with macro dynamism and economic liberalization. Therefore, we argue that FDI growth in response to RTAs would depend on the following factors:

- Macro dynamism
- Multilateral liberalization

It is, as a result, important to examine these factors to assess the prospects of intra-regional FDI.

5.1 Macro economic dynamics

High growth prospects

South Asia in recent years has been one of the most dynamic regions of the world in terms of economic transformation (Table 17). Low dependency rate with large working population offers a tremendous opportunity for economic growth in South Asia, provided that the greater labor supply is productively employed, and that savings and investment increase. Growth prospects are bright for the short and medium term for South Asia (Global Growth Prospects 2007). Greater regional integration is cited as one of the factors that contributed to this growth in the region (Global growth Prospects, 2007). Dramatic economic growth and its consequences have created tremendous opportunities for investors.

Large markets

Evidence suggests that market size offered by a regional agreement is crucial for determining the success of the region in attracting FDI. The combined size of the SAARC countries is around $ 1 trillion. In terms of PPP it is 4.5 trillion, which ranks fourth in the world after the US, EU and China and is higher than even Japan ($ 4.2 trillion in 2006). The combined size of population is 1.5 billion which constitutes 23 per cent of the total world population. It is expected to grow at the rate well above 1per cent in all the countries. Large markets are an incentive for TNCs to invest.

Industrial Dynamism

The change from traditional to modern manufacturing under way in most of these countries is creating new opportunities of investment and demand higher skills and technologies that are likely to enhance the role of FDI.

Table 17: Macro economic dynamics of South Asian Economies

	India	Bangladesh	Nepal	Pakistan	Sri Lanka	Bhutan	Maldives	Total
PPP GDP (2005-6)	3787	296	42	366	89	2.9	1.25	**4580**
GDP $ mn (2005-6)	785	60	7.3	107.3	23.48	.84	.82	**983.1**
Population	1049.5	143.8	24.6	149.9	18.9	2.2	0.339	**1389.2**
Median Age (yrs)	24.4	21.5	19.9	19.4	29.1	20.2	17.5	**21.7**
Population growth rate 2004-20	1.3	1.6	1.8	2.1	1	2.1	2.7	**1.8**
GDP growth rate	*8.1*	*6.2*	*2.8*	*7.6*	*5.8*	*7*	*9*	**6.6**
Export	25	17.2	10.3	14.7	10.3	39.3	17	**19.1**
Imports	34.4	15.3	15.7	30	13.3	28.8	24	**23.1**

Source: World Development Indicators, World Fact Book, Royal Monetary Authority Annual Report

Emergence of the Service sector

The service sector has emerged as the major contributor of income in South Asian countries accounting for more than 50 per cent of the region's GDP. Irrespective of the debate that has been raging over service- based growth, one can argue that this has opened enormous possibilities of FDI through sectoral linkages.

5.2 Multilateral Liberalisation

The process of economic liberalisation was initiated at different points of time in diverse countries but as discussed above they gained momentum in the 1990s. The second phase of liberalization was initiated in the post-2000 period. Major reforms were carried out in the areas of trade policy and the exchange rate system and fiscal and financial management. These policies have reduced distortions and increased efficiency and cleared the uncertainty about the future. Most countries have acceded to the WTO. Since WTO commitments are mandatory in nature, WTO membership will offset the policy doubts created by political and bureaucratic interventions and produce a "locking" effect. This is also likely to make a positive impact on both intra and extra regional FDI because the two are complementary.

6. Challenges and Constraints

The above analysis suggests that the prospects for FDI growth are good and would improve with deeper integration. These arguments notwithstanding, there are several factors that can impede growth of FDI flows both intra and extra regional. These are discussed below.

Political factors

Despite the economic stakes, political compulsions are preventing the authorities, in some instances, from encouraging FDI movement between contiguous or physically adjacent countries. Bilateral relations there are unfortunately defined by mistrust and antagonism[18].Tense relationships, mired in narrow nationalism, have discouraged active involvement of companies. Regional agreements thus could not go far in overcoming local hurdles.

Psychological factors

[18] For instance, in 2005, leading business houses— led by Rahul Bajaj's Bajaj Auto, Lalit Suri's Bharat Hotels and the Tata group, sought permission to set up their ventures in Pakistan but were rejected. Later, TCS was allowed to set up its production base there. Similarly, ninety-five local and foreign companies, including six Indian firms, applied to the Pakistan Telecom Authority (PTA), seeking licence to initiate long- distance international (LDI) and local loop (LL) operations when it opened up its telecom sector. But there were reservations about allowing Indian firms owing to problems in bilateral relations. TATA submitted an expression of interest with the Bangladesh Board of Investment (BoI) in October, 2004. TATA's US$2 billion proposal included the setting up of a steel plant and projections in fertilizer, coal and electricity. However, it has not yet received the approval (Bhattacharya, 2007 for discussion). The experiences of other countries might be similar. Kelegama and Mukherjee (2007) have highlighted problems that Indian and Sri Lankan companies are facing across borders.

Efforts are being made to promote FDI from the developed countries. It is believed that TNCs from there can bring superior technologies and that the spillover effects will modernize the local economies. This psyche, inherited from colonial rule, is one of the hurdles in the way of promoting FDI from within the region.

Restrictions on outward investment

Liberalizing the inward FDI regime alone is a necessary, but insufficient, condition for intra regional FDI flows. Promotion of such FDI requires eliminating restrictions on outward-oriented FDI flows also. Outward FDI flows are highly restricted in South Asian countries owing to their implication for foreign exchange outflows. The policy for Indian direct investment abroad has been substantially liberalized over the past three years and there has been tremendous increase in outward investment originated in the country. However, there are ceilings on specified outward investments. In other countries also it is tightly regulated with ceilings on the overall flows. These restrictions can affect the patterns of FDI flows by diverting them to sectors which require less capital and are less scale- intensive. These ceilings need to be addressed.

Structural barriers

Governance: Leading from a state of extreme over-regulation, the trend since 1991 has been a gradual decrease of governmental obstruction of private business. Many regulatory changes, however, have not yet been politically possible to implement. These economies are still hobbled by excessive rules and a powerful bureaucracy and leaders with broad discretionary powers (see USTR 2006).

Table 18: Regional Governance indices

	Average time spent with tax officials	**Time spent in government regulations**	**Official predictability**	**Unofficial payments**	**Bribes to Tax officials**	**Bribes to secure contract**
East Asia & Pacific	4.91	7.25	51.86	1.81	33.59	1.82
Europe & Central Asia	2.82	5.4	45.13	1.04	44.79	1.57
Latin America & Caribbean	2.75	10.39	40.11	1.52	6.83	2.94
Middle East & North Africa	3.52	9.94	50.87	2.72	40.09	1.3
OECD	1.65	2.97	57.52	0.13	28.26	0.55
South Asia	**3.19**	**7.1**	**61.52**	**2.02**	**46.94**	**3.32**
Sub-Saharan Africa	4.41	8.55	48.97	1.94	20.74	4.04

Source: Enterprise surveys by IFC

The IFC research study measured the number of steps an investor must take to start up a firm, the length of time required to complete mandatory market entry procedures and associated costs[19] for several countries. Their findings for South Asia indicate they are just slightly better than the Sub Saharan countries in most cases (Table 18). Transparency International, the global watchdog on corruption, has also reported high levels of corruption in these countries (TI, 2006).

Infrastructure: Poor infrastructure is stated to be another structural blockage that these countries are facing. Table 19 Shows that in most cases they lag behind Sub Saharan countries.

Table 19 : Infrastructure indices of selected regions

	Delays in electrical connection	No.of electrical outage	Value lost due to electrical outage	No. of water supply failure	Delays in telephone connections
East Asia & Pacific	12.02	7.04	2.39	1.86	9.32
Europe & Central Asia	7.4	11.65	3	5	10.33
Latin America & Caribbean	26.49	14.91	3.26	9.06	37.47
Middle East & North Africa	43.84	44.27	4.69	34.54	51.46
OECD	8.32	1.14	2.25	0.18	7.91
South Asia	**48.18**	**109.2**	**5.56**	**7.57**	**53.85**
Sub-Saharan Africa	38.12	51.96	4.78	29.82	51.39

Source: Enterprise Surveys, IFC 2006

Trade Rules: In a recent study, Chaturvedi (2007) has discussed the current status of trade rules and the prospects of their facilitation. He argues that complex customs, rules and long (customs) delays increase the costs and hence competitiveness of exporters affecting not only trade but also efficiency seeking investment (see also Doing Business Report of the World Bank). The IFC report puts these countries just above Sub Saharan countries (Table 20).

[19] The Enterprise Analysis unit provides Enterprise Survey data on the investment climate in 94 countries, based on surveys of more than 60,000 firms. Enterprise surveys measure business perceptions of the investment climate. Using stratified sampling, surveys are taken of hundreds of entrepreneurs per country who describe the impact of their country's investment climate on their firm. Responses reflect their managers' actual experiences. They span all major investment climate topics from infrastructure to crime. "Doing Business" Report of the World Bank also provides a similar database.

Table 20: Trade Rules in Selected Regions of the World

	Average export clearance time	Longest export clear time	Average time to claim imports from customs	Longest time to claim imports from customs
East Asia & Pacific	3.71	5.98	4.89	8.98
Europe & Central Asia	2.91	5.4	3.51	25
Latin America & Caribbean	4.79	9.16	7.22	14.72
Middle East & North Africa	5.14	9.43	10.3	21.29
OECD	4.63	8.33	5.28	9.4
South Asia	**7.72**	**12.66**	**10.08**	**17.54**
Sub-Saharan Africa	4.45	8.69	7.37	14.55

Source: IFC

Legal system: A fundamental impediment to investment in many South Asian countries is the existence of weak and slow legal systems in which the enforceability of contracts is uncertain. Foreign investors face opaque legal structures. Firms complain that basic legal procedures are neither quick nor routine. There is no penalty for delaying proceedings (Table 21).

Table 21: Legal System Standards across different regions

	Confidence level in the legal system
East Asia & Pacific	65.83
Europe & Central Asia	55.18
Latin America & Caribbean	55.48
Middle East & North Africa	66.63
OECD	73.6
South Asia	**53.72**
Sub-Saharan Africa	60.42

Extremism and political instability

Extortion of money from businesses by ruffians claiming political backing is common in Bangladesh. Power struggles, the rapid rise of fundamentalism and militarization, have weakened the political system. For nine years, Nepal was wracked by a violent Maoist insurgency, with the conflict initially confined to the mid-western districts.

There are significant threats to foreign interests in Pakistan, both from al-Qaida and Taliban elements and domestic terrorist organizations. In India, there are violent movements in Kashmir and some northeastern States. Sri Lanka has been plagued by the LTTE. Only Maldives and Bhutan have a long record of political tranquillity.

Rigid labour laws and Trade unions

There are more than 6,300 registered trade unions in Bangladesh, with in excess of 1.9 million union members. Bangladesh's labour unions, most of them associated with political parties, are often militant. In India, there are more than seven million unionized workers. Most unions are linked to political parties and have narrow personal stakes. In Pakistan, however, organized labour comprises a very small percentage of the total workforce. Although associations are not expressly prohibited, the Government does not recognize the right to form unions or to strike. Hence, labour actions and disputes are rare.

Visas

The exclusion of cross border movement of labour poses grave difficulties for investors. The problems faced include long procedures, high costs, frequent renewals and the attitude towards investors..

7. Conclusion

The slow progress and modest achievements of regional integration in South Asia have generated significant skepticism about its role as an effective arrangement. However, the above analysis indicates that regional integration has the potential to promote economic development in individual countries irrespective of size and the level of growth. This potential can be exploited only through a deeper form of cooperation. The success of the India-Sri Lanka FTA underlines the hypothesis. A number of challenges remain. Unresolved structural weaknesses, institutional bottlenecks, political movements, narrow nationalism and mutual mistrust are several factors that explain the failure of the region to tap its potential. These problems themselves provide strong motivation for strengthening cooperation. It is only through deeper regional collaboration that these shortcomings can be addressed and rectified. Plans for the creation of the SAARC Development Fund, the SAARC Development Bank and the SAARC University, need immediate implementation along with the lowering of investment barriers across geographically adjacent territories. Increased investment flows will improve the competitiveness of regional firms in global markets. Generally, it is believed that inward investment is beneficial for the host countries' firms. But it is important to note that outward investment itself works as a catalyst for improving commercial competitiveness. Regional cooperation, by promoting cross border investment, will offer opportunities to firms, especially from smaller countries, to grow in terms of size and capabilities to compete globally. Furthermore, it can help in raising efficiency and industrial restructuring. It is essential that South Asian countries take a big stride forward to forge deeper integration.

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