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Nagesh Kumar







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Capital Flows and Development: Lessons from South Asian Experiences

by Nagesh Kumar *

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Abstract

Foreign capital flows have emerged as key channels of global economic integration all across the world over the past two decades. While foreign direct investment (FDI) flows have been undertaken for a long time by multinational enterprises (MNEs) in the course of their overseas expansion, foreign portfolio investments (FPI) representing equity and debt flows unaccompanied by management control have become highly visible and often dominant components of the foreign capital flows in recent years with the rise of foreign institutional investors (FIIs) and sovereign wealth funds on the horizon that seek to make quick returns through short term speculative activities abroad. This paper summarizes the experiences of South Asian countries in attracting FDI and FPI and reviews recent trends, patterns and prospects for these flows and their developmental impact. As the region emerges as a source of FDI as well, the paper also briefly touches upon the trends in these flows and concludes with some policy lessons.

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Capital Flows and Development: Lessons from South Asian Experiences

Nagesh Kumar

1. Introduction

Foreign capital flows have emerged as key channels of global economic integration all across the world over the past two decades. While foreign direct investment (FDI) flows have been undertaken for a long time by multinational enterprises (MNEs) in the course of their overseas expansion, foreign portfolio investments (FPI) representing equity and debt flows unaccompanied by management control have become highly visible and often dominant components of the foreign capital flows in recent years with the rise of foreign institutional investors (FIIs) and sovereign wealth funds that seek to make quick returns through short term speculative activities abroad.

FDI flows represent longer term investments made abroad bringing together with capital and entrepreneurship, technology and managerial know how and sometimes even market access. Hence, they are seen by developing countries as catalysts of development. Therefore, most developing countries actively seek to attract foreign direct investment (FDI) flows with different policy instruments. FDI inflows received by developing countries have grown rapidly into sizeable magnitude, from an annual average of $25 billion in the second half of the 1980s to a peak of nearly $630 billion in 2008 before declining to $478 billion in 2009 in the aftermath of the crisis. Furthermore, with the rise of emerging economies, the share of developing economies in global flows has consistently improved from 26 per cent in 2001 to 36 per cent in 2008 to 43 per cent in 2009 as FDI inflows to developed countries were hit much more severely from the financial crisis. FPIs, in contrast, tend to have limited potential of contributing to development, if at all, given their short-term and speculative nature. Their distribution across countries is highly uneven as they target only the fast growing emerging economies to benefit from their dynamism. In fact they are often seen to be bringing volatility to the financial and exchange rate markets. Hence, a number of emerging market economies are seeking to moderate their volatility through a variety of capital controls.

Recent years have also seen the rise of FDI and FPI flows in South Asia. This can be partly attributed to substantial liberalization of their policy regimes since the early 1990s. With their economies embarking on robust growth trajectory in the new millennium, they have also begun to attract increasing attention of MNEs as well as FIIs as destinations for investments. The current decade also marks the beginning of the emergence of developing countries as sources of outward investments. Developing country enterprises especially in India have increasingly used outward FDI as a strategic tool for strengthening their international competitiveness. As a result FDI flows have begun to be of bi-directional in nature rather than only one sided with South Asian countries playing host.

Against that background, this paper summarizes the experiences of South Asian countries in attracting foreign direct and portfolio investments and reviews the recent trends, patterns and prospects for these flows and their developmental impact. As the region emerges as a source of FDI as well, the paper also briefly touches upon the trends in these flows especially the intraregional flows. It concludes with some policy lessons.

2. Evolution of policy regime towards FDI and FPIs in south Asia

Most of the South Asian countries offer an increasingly liberal policy regime to FDI inflows. The FDI policy regime began to be liberalized from early 1990s when India liberalized her FDI policy regime dramatically as a part of a New Industrial Policy adopted in July 1991 after pursuing a rather selective policy towards FDI after four decades. The new policy marked a major departure from the past with the abolition of industrial licensing system except where it is required for strategic or environmental grounds, creation of a system of automatic clearance of FDI proposals fulfilling the conditions laid down, such as the ownership levels of 50 per cent, 51 per cent, 74 per cent and 100 per cent foreign equity and opening of new sectors such as mining, banking, insurance, telecommunications, construction and management of ports, harbours, roads and highways, airlines, and defence equipment, to foreign owned companies subject to sectoral caps. Foreign ownership up to 100 per cent is permitted in most manufacturing sectors – in some sectors even on automatic basis-- except for defence equipment where it is limited to 26 per cent and for items reserved for production by small-scale industries where it is limited to 24 per cent (Kumar 2005a). India has also entered into Double Taxation Avoidance Treaties with 65 countries, and Bilateral Investment Promotion and Protection Agreement (BIPAs) with 58 countries. Recognizing the importance of outward investment for competitiveness of enterprises, the policy governing outward FDI has also been liberalized since 1991. With the build up of foreign exchange reserves, the limits for outward investments have been gradually relaxed and Indian enterprises are now permitted to invest abroad upto 100 per cent of their net worth on automatic basis.

The liberalization of FDI policy in India in 1991 was followed by similar liberalizations in Pakistan and Nepal. Sri Lanka had liberalized her FDI policy regime much earlier in 1978. Bangladesh has offered a national treatment to FDI since 1980. The key features of the FDI policy regimes of the South Asian countries (as summarized in Table 1) include upto 100 per cent foreign ownership in most sectors except for a few on the negative list due to sensitivities and security concerns such as arms and ammunition. They permit full repatriation of capital and remittances of profits, dividends, technical fees and royalties. They also offer a number of incentives such as tax holidays for certain number of years, special packages of facilities and incentives in the export processing zones and have entered into bilateral investment promotion and protection treaties and double taxation avoidance treaties with large number of partner countries including major source countries of investments.

Since the early 1990s, major stock markets in Asia have also been gradually opened to international investors and trading has expanded rapidly. Among the South Asian countries, India is most exposed to portfolio inflows. In September 1992, the Indian government announced guidelines for investments by foreign institutional investors (FIIs) in the Indian capital market. FIIs were now welcome to invest in all types of securities traded on the

primary and secondary market with full repatriation benefits and without restrictions on either volume of trading or lock-in-period.

Table 1: Policies and Incentives of Foreign Direct Investment in South Asia

	Bangladesh	India	Sri Lanka	Pakistan	Nepal
Entry restrictions	▪ Arms, ammunition & defence products, nuclear energy, security printing and minting, forestry in reserved forest areas, and railways.	▪ Arms and ammunition, atomic energy, nuclear power, agriculture and plantations, real estate business, settlements, retail trading (multi brand), atomic energy and lottery business, gambling and betting, rail way, coal, lignite, mining of iron, manganese, chrome, gypsum, sulphur, gold, diamonds, copper, zinc. ▪ Investment in stock markets and real estate requires prior approval.	▪ Money lending, pawn broking, retail trade with a capital of less than $ I million, coastal fishing, education	▪ Arms and ammunitions. high explosives. radio active substances, alcoholic beverages or liquors.	▪ Business, management, consulting, accounting, engineering, legal services, defense sector, alcohol, cigarettes agencies, retail sales.
Foreign ownership	▪ Up to 100%	▪ 100% in most sectors except insurance (26%), mining (74%). Sectoral caps apply in service sectors.	▪ 100 per cent foreign ownership. 40% for negative list.	▪ 100% in most sectors, except agriculture 60%, service sector 100% to 60% reduction within 2 years.	▪ Up to 100%
Profit transfer and convertibility	▪ Full repatriation of invested capital, profit and dividend allowed	▪ No restriction on remittances for debt service or payments for imported inputs. Dividend remittances permitted without approval from the RBI. ▪ All profits, dividends, royalty, know how payments can be repatriated.	▪ No restriction on repatriation of earnings and fees. Foreign exchange restrictions for current a/c transaction removed	▪ Full repatriation of capital, capital gains, dividends and profits, is allowed 100% foreign equity allowed on repatriable basis.	▪ All profits and dividends are not guaranteed for repatriation.
Taxation	● Tax holiday facilities for 5-7 yrs depending on location of the industry.	● 40% with especial tax treatment for infrastructure sector ● Foreign nationals working in India are generally taxed only on their Indian income. ● Corporate tax holiday for a block of 10 years out of 20 years. Tax and duty concessions for mega power projects.	● 35-39%. Tax relief as first year allowance for category A,B,C,D, for expansion, balancing, modernization & replacement in existing industries	● Full tax holiday from 2-20 yrs, up to 0% tax on turn over $25 m in EPZ	● 25% with no income tax on profit from export. Hydropower developers exempt first 15 yrs.
Other incentives	▪ Duty free import of raw materials, tax holiday of 10 yrs, concessionary tax for 5 yrs, fully serviced plots, factory building etc.	▪ 10 yr tax holiday for knowledge based start-ups. Almost 659 units EPZ in 8 sectors, automatic approval for foreign equity investments up to 51% ▪ Issue of equity shares against lump sum fee, royalty and external commercial borrowings in convertible foreign currency already due for payment/repayment permitted	▪ No import duty or turnover tax on machinery and equipment. Concessionary tax of 15%. Import duty exemption on project related goods, exemption from turnover tax on sales and exchange control ▪ An initial tax holiday, often for five years, followed by a short period of a concessional income tax rate and finally a long-term concessional rate, varying from 15 to 20 per cent depending on the industry	Custom duty of 5% chargeable on import of plant, machinery & equipment, not manufactured locally. Zero rated sales tax on import of plant, machinery & equipment. Locally manufactured plant, machinery & equipment are also exempted from payment of sales tax.	Hydropower developers exempted from income tax for first 15 yrs, no income tax on profit from exports, tax incentives to locate outside the Katmandu No EPZ or free ports.
Bilateral Tax Treaties	● 20 countries	● 57 countries	● 39 countries	● 23 countries	● 3 countries
Agreement of double taxation avoidance	● 20 countries	● 63 countries	● 52 countries	●52 countries	● 3 countries

Source: Drawn from Moazzem (2006), Kumar (2005a), Kumar and Sharma (2009), Haque and Ghani (2009), Rashid (2009), Karmacharya and Maskay (2009), Weerakoon (2009), RIS (2008) among other sources.

3. Capital inflows in South Asia: trends and prospects

As observed earlier, South Asian countries have been receiving increasing magnitudes of FDI and FPI flows over the past years following liberalization of their policy regimes and their emergence as fast growing economies.

3.1 FDI flows in south Asia

FDI inflows attracted by South Asia have steadily grown from $6 billion to $48 billion over 2001 to 2008 before declining to $ 38 billion in 2009 under the shadow of the crisis (Table 2). The growth of FDI inflows to the region has accelerated since 2005 to an annual average rate of 68 per cent, with the bulk of the inflows going to the larger South Asian countries namely India and Pakistan, which accounted for 97 per cent of total FDI inflows to the region in 2009.

In India which is by far the largest host country of FDI in the sub-region, FDI inflows have grown from $7.6 billion in 2005 to $20.3 billion in 2006 and nearly doubling in 2008 to $40 billion, representing an annual average increase of about 76% during the last three years. Pakistan has also attracted growing magnitudes of FDI inflows rising from $0.5 billion in 2003 to $5.6 billion in 2007. However, in 2008 FDI inflow declined marginally to $5.4 billion, with the growing security concerns.

In Bangladesh, FDI inflows increased during 2003 to 2005 from $350 million to $845 million. However, in 2006 FDI inflows fell to $793 million and in 2007 continued to register a decline to $666 million. A significant recovery occurred in 2008 reaching a new high of $1086 million. In the case of Sri Lanka, after stagnating during 2001 to 2005 at around $200 million, FDI inflows in 2006 increased remarkably to $480 million and to $752 in 2008, reflecting a much improved confidence in the country's growth potential with the easing of the security concerns.

In Nepal FDI inflows have dried up over the years due to continuing political unrest while in Maldives and in Bhutan FDI inflows have stagnated at very small levels, never increasing more than two digits over the years. Afghanistan has emerged as a significant host of FDI in recent years with $ around 250 million FDI inflows a year.

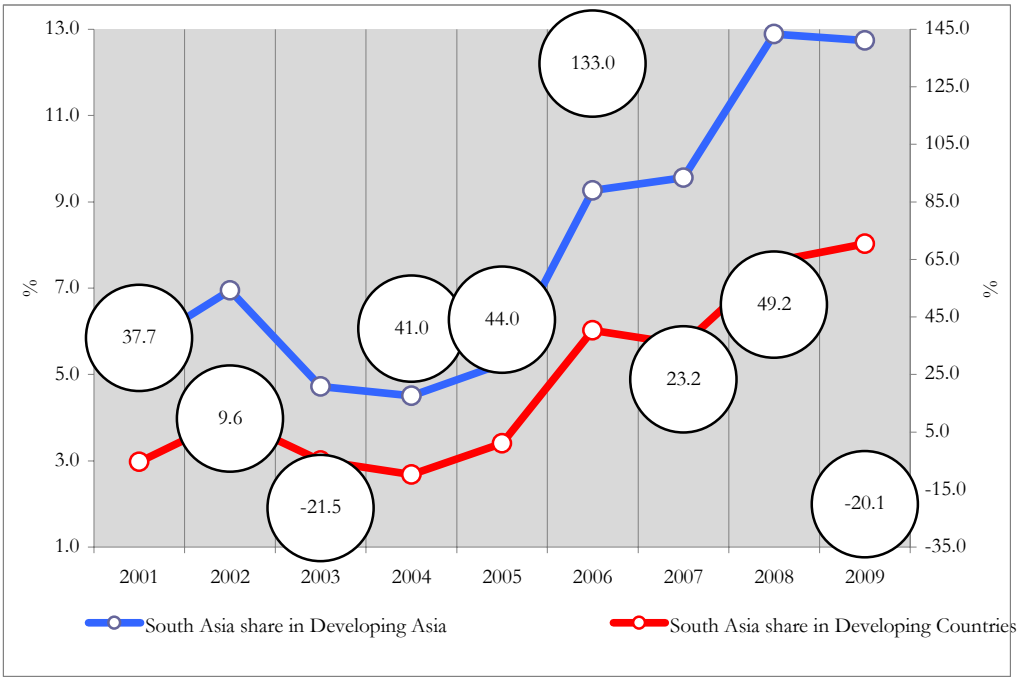
Table 2: Foreign direct investment (FDI) inflows to South Asian countries ($ million)

	2001	2002	2003	2004	2005	2006	2007	2008	2009
World	820 430	629 675	565 160	734 892	973 329	1461 074	2099 973	1770 873	1114 189
Developing economies	215 421	175 935	183 994	290 397	329 292	433 764	564 930	630 013	478 349
Developing economies: Asia	113 936	101 185	116 928	172 910	213 751	282 127	336 922	372 739	301 367
Southern Asia	6 415	7 033	5 525	7 787	11 216	26 133	32 198	48 038	38 390
Afghanistan	1	50	58	187	271	238	243	300	185
Bangladesh	355	328	350	460	845	793	666	1 086	716
Bhutan		2	3	3	9	6	73	30	36
India	5 472	5 627	4 323	5 771	7 606	20 336	25 001	40 418	34 613
Maldives	12	12	14	15	9	14	15	12	10
Nepal	21	- 6	15		2	- 7	6	1	39
Pakistan	383	823	534	1 118	2 201	4 273	5 590	5 438	2 387
Sri Lanka	172	197	229	233	272	480	603	752	404
South Asia share in Developing Asia (%)	5.6	7.0	4.7	4.5	5.2	9.3	9.6	12.9	12.7
South Asia share in Developing Countries (%)	3.0	4.0	3.0	2.7	3.4	6.0	5.7	7.6	8.0

Source: author based on UNCTAD's FDI online database (2010).

To put South Asia in a global and regional comparative perspective, we look at the trends in its shares. South Asia has been a relatively small destination for FDI inflows with only around 13% of inflows attracted by developing Asia and about 8% of FDI inflows in developing countries in 2008. However, its share shows a rising trend in recent years, especially since 2004 as seen in Figure 1. South Asia's relative position as a destination for FDI among other Asian developing countries is dramatically improving. From 2005 to 2008 its share in FDI inflows in developing countries shows a remarkable rise, more than doubling. This may be attributed to transition of the South Asian countries to a higher growth trajectory since 2003 with India's growth rate averaging nearly 9 per cent during 2003-08 (UN-ESCAP 2010). The other aspect of South Asia's performance as a host relative to other sub-regions in the developing world is its resilience to the global financial crisis. During the 2008-09, share of South Asia in FDI inflows to developing countries continued to rise from 5.7 per cent in 2007 to 7.6 per cent in 2008 to 8 per cent in 2009 as the region continued to grow at a robust pace even in the worst of the economic crisis. It is likely that in the coming years, the region will further strengthen its place as a host of FDI given very optimistic outlook for the largest economy of the region, viz. India for the coming decade.

Figure 1. Growth and Share of South Asia in FDI inflows, 2001 to 2008



Note: figures in circles indicate growtb rates of FDI inflows in South Asia.
Source: author based on online UNCTAD's FDI database (2010).

In order to examine the relative importance of the FDI in different economies, we look at the patterns in terms of the share of FDI inflows in gross fixed capital formation. This proportion summarized in Table 3 suggests that generally the relative importance of FDI as a source of capital investment is smaller in South Asian countries compared to the developing Asian countries or developing countries, but in recent years it is catching up with the levels prevalent in other Asian developing countries, as is clear from Figure 2. The proportion of FDI in capital formation in South Asia has steadily increased especially since 2004 more than doubling from 3.8 per cent to 8.5 per cent over 2004-08. With this steady increase, the South Asian average is looking up to reach a developing Asian countries' average of 10-11 per cent. Between the countries, the pattern that emerges is that for India, Pakistan and Sri Lanka, the share of FDI in capital formation has been rising steadily in the recent years. Most dramatic rise has been in the case of Pakistan where the share of FDI has gone up from 5-7%, to around 18%. In India's case, share of FDI in capital formation has increased from around 3% to 10% in 2008. In Sri Lanka it has increased from around 6 per cent to 7.3 per cent. In Bangladesh's case the share of FDI has fluctuated around 5 per cent and does not show a trend.

In Afghanistan's case, FDI accounts for a rather high proportion of capital formation ranging around 14 per cent and was 16.7 per cent in 2008. In Bhutan the share has varied widely depending upon single large projects accounting for a large share (11%) in 2007 but otherwise varying between 1-4%. In Maldives the share of FDI has gradually dried up from a significant at around 7% in 2003. In Nepal it has remained negligible through out the period.

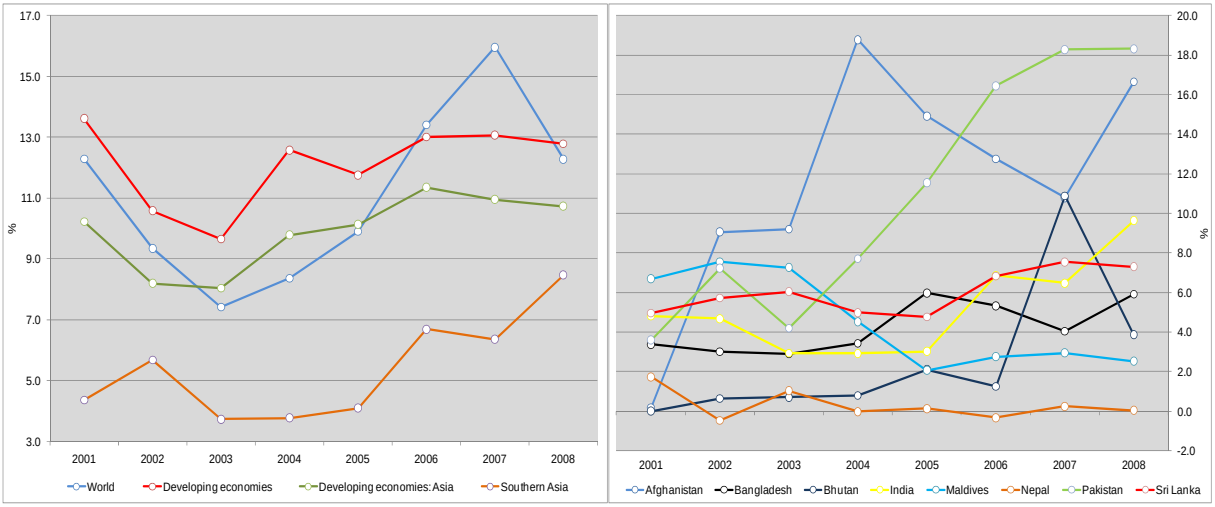
Table 3: Foreign direct investment (FDI) inflows as a percentage of gross fixed capital formation (GFCF) in South Asia (%)

	Annual Average 1997-2000	2001	2002	2003	2004	2005	2006	2007	2008
World	13.7	12.3	9.3	7.4	8.4	9.9	13.4	16.0	12.3
Developing economies	14.0	13.6	10.6	9.7	12.6	11.8	13.0	13.1	12.8
Developing Asian economies	10.9	10.2	8.2	8.0	9.8	10.1	11.4	11.0	10.7
Southern Asia	2.8	4.4	5.7	3.7	3.8	4.1	6.7	6.4	8.5
Afghanistan	0.3	0.2	9.1	9.2	18.8	14.9	12.8	10.8	16.7
Bangladesh	5.4	3.4	3.0	2.9	3.4	6.0	5.3	4.0	5.9
Bhutan	0.0	0.0	0.6	0.7	0.8	2.1	1.2	10.9	3.9
India	2.9	4.8	4.7	2.9	2.9	3.0	6.9	6.5	9.6
Maldives	7.0	6.7	7.6	7.3	4.5	2.1	2.8	2.9	2.5
Nepal	0.8	1.7	-0.5	1.0	0.0	0.1	-0.3	0.2	0.0
Pakistan	5.5	3.6	7.2	4.2	7.7	11.5	16.4	18.3	18.3
Sri Lanka	6.0	5.0	5.7	6.0	5.0	4.8	6.8	7.5	7.3

Source: author based on online UNCTAD's FDI database (2010).

Note: Southern Asia includes the Islamic Republic of Iran.

Figure 2. Trends in the Share of FDI Inflows in Gross Fixed Capital Formation, 2001 to 2008



Source: author based on online UNCTAD's FDI database (2010).

3.1.1. Investment climate and prospects for FDI inflows

The empirical studies of determinants of FDI inflows have found an important role of market size, extent of urbanization, quality of infrastructure, geographical and cultural proximity with major sources of capital, and policy factors, e.g., tax rates, investment incentives, performance requirements, among other factors (Kumar 2000). In the light of these findings, while South Asia's large population base (especially of countries like India, Pakistan and Bangladesh) may be an advantage, their low income levels, low levels of urbanization and relatively poor quality of infrastructure are disadvantages. Furthermore, South Asian countries also do not

have the benefit of geographical and cultural proximity with major sources of FDI such as the US, Europe or Japan. However, over time the relative attractiveness of the region is improving with rapid growth that is expanding market size and other aspects of macroeconomic performance. A recent inter-temporal analysis for India has found a broad correspondence between the industrial growth rates in a year and FDI inflows received in the following year (Kumar 2005a). Apparently, good industrial performance tends to crowd-in FDI inflows as well.

Among the South Asian countries, the investment climate in India has improved sharply with the acceleration of growth rate since 2003, a sizeable middle class with purchasing power, and with the recognition of its comparative advantage in knowledge-based industries. It is not only evident from the rising magnitudes of FDI inflows but also from the investor confidence surveys conducted by global consultancy organizations. In the FDI confidence index published by AT Kearney, a global consultancy organization, among others, India has moved up from 6th place in 2003 to 2nd in 2005 and stayed there before swapping the third rank with the United States in 2010 (Table 4). Similar enhancement in the India's ranks has been reported by the surveys of investors conducted by the Japanese Bank of International Cooperation (JBIC) as well as in UNCTAD's *World Prospects Survey 2009-2011*, where India is ranked as the third most preferred FDI location. This is in sharp contrast to the World Bank's studies on *Ease of Doing Business* based on perception surveys that tend to put South Asian countries at the poor ranks (on average 107th rank). It is clear therefore that foreign investors get attracted to a country by the potential of benefiting from its dynamism and are wiling to put up with hardships rather than going to countries with easier business conditions but with poorer prospects of making profits!

Table 4. Select Asian Rankings in FDI Confidence Index

	2003	2004	2005	2007	2010
China	1	1	1	1	1
	(1.97)	(2.03)	(2.19)	(2.21)	(1.93)
India	6	3	2	2	3
	(1.04)	(1.4)	(1.95)	(2.09)	(1.64)
Thailand	16	20	20	..	..
	(0.83)	(0.87)	(1.05)		
Singapore	28	18	18	7	24
		(0.91)	(1.07)	(1.75)	(1.19)
Malaysia	23	15	..	16	21
	(0.67)	(0.92)		(1.63)	(1.22)
Hong Kong	22	8	10	5	14
	(0.69)	(0.99)	(1.21)	(1.78)	(1.28)

Source: author based on A.T. Kearney, *Foreign Direct Investment Confidence Index* different years.
Note: Index values are in parentheses. Other South Asian countries are not included in the Rankings.

3.2. South Asia's emergence as a source of outward FDI and intraregional investments

Another important trend with respect to FDI in South Asia is India's emergence as a significant source of FDI flows. Therefore, FDI flows now represent a two way street unlike in the past when the region would only serve as the host of FDI flows generally. UNCTAD has reported nearly $19 billion of outward FDI flows originating from South Asian countries in 2008 before declining to $15 billion in 2009. An overwhelming bulk of these investments originated in India but also $62 million from Sri Lanka and $49 million from Pakistan in 2008 (Table 5).

Table 5. Foreign direct investment (FDI) outflows originating in South Asian countries ($ million)

	2001	**2002**	2003	2004	2005	2006	2007	2008	2009
World	745 662	536 572	563 399	929 641	878 988	1 396 916	2 146 522	1 857 734	1 100 993
Developing economies	82 882	49 642	45 540	120 445	122 707	215 282	285 486	292 710	
Developing economies: Asia	49 448	37 240	22 947	90 306	84 301	144 448	223 081	296 286	229 159
South Asia	1 449	1 723	1 932	2 247	3 063	14 486	17 456	18 998	15 274
Bangladesh	21	4	6	6	3	4	21	9	15
India	1 397	1 679	1 879	2 179	2 978	14 344	17 281	18 499	14 897
Pakistan	31	28	19	56	44	109	99	49	14
Sri Lanka	0	11	27	6	38	29	55	62	20

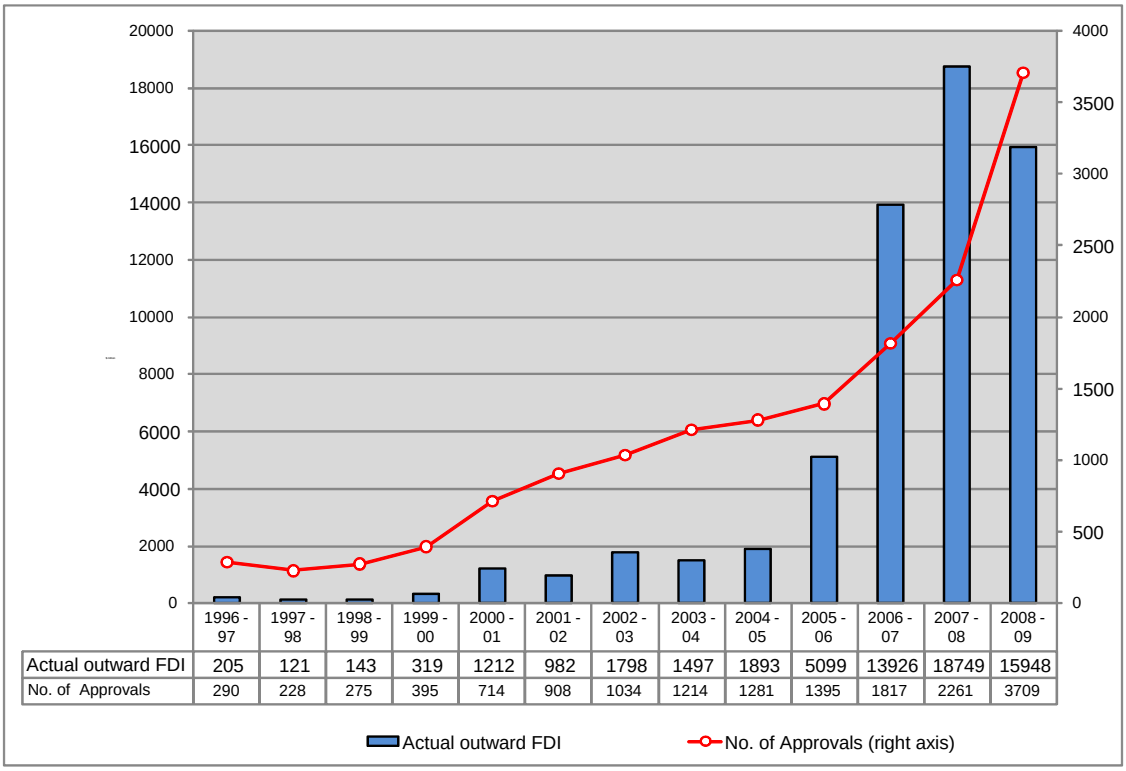
Source: author based on online UNCTAD's FDI database (2010).

Considering that South Asian countries are generally low income countries, their emergence as sources of FDI is an interesting development and hence deserves a comment. In particular, involvement of Indian companies in large cross-border acquisitions e.g. Tata Steel-Corus, Hindalco-Novelis, and Tata Motors-Jaguar/Land Rover, among others, have helped in focusing attention on their emergence on the global scene. The growing recognition of India as a potential source of FDI has led a number of investment promotion missions from across the world including developed countries visiting India.

Although Indian companies have been investing abroad since early 1970s, the magnitudes of investments were quite small until mid-1990s. However, the magnitudes as well as numbers of outward investments have suddenly swelled since 2000 to around $1.5 billion per annum. Since 2005-06 the outward investments have climbed new heights as apparent from Figure 3. In 2005-06 the magnitude of outward investment by Indian companies was nearly $5 billion and it jumped to $14 billion in 2006-07. In 2007-08 the value increased to $19 billion, before moderating slightly to $16 apparently in the wake of the global financial crisis. Rising numbers and magnitudes of outward investments by Indian companies have made it an important and perhaps more dynamic aspect of increasing global economic integration of Indian economy along with trade in goods and services and inward FDI. Emergence of India as a source of outward FDI seems to be a part of the broader new trend of outward investments from the emerging countries such as China, Brazil, India and South Africa.

India's emergence as a source of FDI outflows is impressive for its level of development with around 4 per cent share of outward FDI in gross fixed capital formation compared to around 2.9 per cent in China's case (see Kumar 2008).

Figure 3. Outward FDI by Indian Enterprises, 1996 to 2009



	1996 - 97	1997 - 98	1998 - 99	1999 - 00	2000 - 01	2001 - 02	2002 - 03	2003 - 04	2004 - 05	2005 - 06	2006 - 07	2007 - 08	2008 - 09
Actual outward FDI	205	121	143	319	1212	982	1798	1497	1893	5099	13926	18749	15948
No. of Approvals	290	228	275	395	714	908	1034	1214	1281	1395	1817	2261	3709

Source: author based on India, Ministry of Finance and RBI.

In the context of emergence of outward investments from South Asian countries, the question arises whether that is leading to intraregional FDI flows in South Asia. Indian companies have been among the major sources of FDI in Nepal and Sri Lanka even though the share of South Asia in Indian outward FDI is rather small (Kumar 2008). In particular, the India-Sri Lanka bilateral FTA signed in 1998 and implemented since 2000 has spurred the FDI flows from India making her the 5th largest source of FDI in the country compared to 9th place earlier. Some of these investments made in Sri Lanka are of export-oriented nature exporting back to India taking advantage of duty free imports in the country under the FTA. A number of Sri Lankan companies have also invested in India in recent years even though in small magnitudes (Kelegama and Mukherjee 2007). However, much of the potential of intra-regional FDI flows remains to be realized. These flows are stimulated by the FTAs as is shown by the case of India-Sri Lanka FTA above as enterprises in the partner companies make use of the provisions of FTA for efficiency seeking industrial restructuring across borders, as evident from case studies of ASEAN countries and other regional trading arrangements across the world (see Kumar 2007). Possibly deepening of implementation of SAFTA schedules in the coming years will help in realizing this potential.

3.3 Portfolio investments in south Asia

In South Asia the total portfolio investment liabilities increased from nearly US$16 billion in 2001 to $364 billion in 2007 before declining to $ 218 billion in 2008 as the FIIs began to pull out to cover their losses in the western capital markets in the wake of the global financial crisis. The bulk of portfolio investments have taken the form of equity investments by FIIs. Sharp accumulation of portfolio investment liabilities or stocks in India which largely accounts for the South Asian totals has been a result of existence of well functioning capital markets that had begun to offer good returns as the country moved to a higher growth trajectory since 2003. However, the substantial reduction in the liabilities in 2008 indicates the net outflows from the region thus highlighting the volatile nature of these flows, as will be seen later with a more detailed time series analysis of flows for India.

Table 4: Derived Portfolio Investment Liabilities of South Asian Countries

(US$ Million)

	Investment in:	2001	2002	2003	2004	2005	2006	2007	2008p
Afghanistan	Equity securities	--	--	--	--	5	5	18	--
	Long Term debt securities	--	--	--	1	--	--	--	--
	Short Term debt securities	--	--	--	--	--	1	--	--
Bangladesh	Equity securities	6	14	17	20	44	47	459	202
	Long Term debt securities	10	--	4	--	2	1	25	1
	Short Term debt securities	--	--	--	92	--	194	236	270
Bhutan	Equity securities	--	--	--	--	--	2	--	--
	Long Term debt securities	--	--	--	--	--	--	--	--
	Short Term debt securities	--	--	--	--	--	--	--	--
India	Equity securities	13 378	21 048	45 174	65 136	105 652	160 580	327 705	184 970
	Long Term debt securities	1 783	1 244	1 361	3 251	8 536	17 616	24 196	19 281
	Short Term debt securities	227	304	1 050	3 511	2 195	3 011	5 309	8 860
Maldives	Equity securities	3	15	10	20	13	12	12	26
	Long Term debt securities	--	--	--	--	--	--	2	1
	Short Term debt securities	--	--	--	--	--	--	2	--
Nepal	Equity securities	--	--	--	3	5	--	40	36
	Long Term debt securities	--	--	--	6	--	--	3	8
	Short Term debt securities	--	--	--	--	--	--	--	--
Pakistan	Equity securities	198	342	310	454	538	1 281	3 119	2 365
	Long Term debt securities	249	103	66	122	198	833	1 178	629
	Short Term debt securities	22	23	32	--	16	42	75	51

Sri Lanka	Equity securities	188	76	92	246	259	533	702	330
	Long Term debt securities	136	116	87	102	81	139	689	320
	Short Term debt securities	93	44	59	18	42	40	69	207
Total		16 293	23 329	48 262	72 982	117 586	184 337	363 839	217 557

Source: author based on IMF's Coordinated Portfolio Investment Survey Data, Online 2010.
Notes: --indicates a zero or negligible value.

In terms of prospects for FPI inflows, an important prerequisite for FII investments to come in is the existence of well-developed capital markets giving a good return. Among the South Asian countries only India possesses world class capital markets that are giving some of the best returns in the world as the economy has picked up the momentum. Another channel of FPI flows is GDR/ADR issues in foreign bourses. That route again has high entry barriers for enterprises based in low-income countries. The companies wishing to issue stocks at the international capital markets must, in the first place, be able to demonstrate their competitiveness, follow international norms of disclosure, and be in a position to bear substantial launching expenses before they can hope to raise resources at international equity markets. Since the beginning of the new millennium, a number of Indian companies have successfully raised capital by listing at western stock markets such as at New York Stock Exchange (NYSE) and Nasdaq. As Indian companies become more globalized, this option could become an important channel for capital inflows.

4. Developmental impact of FDI and FPI flows

4.1 Impact of FDI inflows

A useful concept in the context of impact of FDI is of quality of FDI that, first used in Kumar (2002), has since been extensively employed in the literature to define varying developmental impact of FDI inflows. The concept captures the fact that not all FDI projects have a similar developmental impact on host countries. Some may generate substantial welfare gains for the host economy by bringing new technology and introduce new products and skills in the economy and positive spillovers for domestic players, others may crowd out domestic players and hence be immiserizing. The quality of FDI flows was, therefore, defined in terms of the potential of generating greater positive externalities. In what follows, we summarize the findings of literature on some aspects of developmental impact of or quality of FDI

Impact of FDI on Growth and Domestic Investment

FDI inflows could contribute to growth rate of the host economy by augmenting the capital stock as well as with infusion of new technology. However, high growth rates may also lead to more FDI inflows by enhancing the investment climate in the country. Therefore, the FDI – growth relationship is subject to causality bias given the possibility of two-way relationship. A recent study has examined the direction of causation between FDI and growth empirically for a sample of 107 countries for the 1980s and 1990s period. The study finds that FDI-growth relationship in the case of Bangladesh, India, Nepal and Sri Lanka was Granger neutral as the direction of causation was not pronounced and in Pakistan's case there was

evidence of a feedback causality that is FDI caused growth and growth also caused FDI (Kumar and Pradhan 2005). This means that FDI inflows in South Asia have been of mixed quality, some contributing to growth and others coming to take advantage of it. That is why there is no predominant relationship. Furthermore, it has been shown that some times FDI projects may actually crowd-out or substitute domestic investments from the product or capital markets with the market power of their well-known brand names and other resources and may thus be immiserizing (Fry 1992, Agosin and Myer 2000). Therefore, it is important to examine the impact of FDI on domestic investment to evaluate the impact of FDI on growth and welfare in host economy. Examining these relationships in a dynamic setting, Kumar and Pradhan (2005) found that FDI was crowding in domestic investments in Bangladesh, Nepal, and Sri Lanka but the coefficient was not significantly different from zero in the case of India and Pakistan. An explanation for this finding could be that in smaller and lesser developed economies, FDI will have more chances of crowding in of domestic investments because the local industry that may get affected adversely may not exist. Hence, the relationship turns out positive and significant in relatively smaller and poorer economies. In countries such as India and Pakistan, FDI inflows have been of mixed quality some crowding in domestic investments while others crowding out the domestic industry, hence the relationship is not significant. The literature has highlighted the role of performance requirements such as local content regulations and export performance requirements that have been extensively employed by many countries in their process of development for improving the chances of FDI crowding in domestic investments rather than crowding out (Moran 1998, Kumar 2005b). Other studies have also reported similar mixed results. Athukorala (2003) in Sri Lanka's case found FDI to be exerting no independent influence on economic growth and direction of causation seemed to be from growth to FDI rather than the other way round. Agarwal (2005) found the effect of FDI on growth of South Asian countries to be insignificant during 1970s but gradually improved to be positive over 1990s. FDI was found to have more beneficial effect on investment and growth than foreign borrowings that are part of FPI. Joint venture requirements seemed to help in crowding in domestic investments, again highlighting the role of performance requirements.

FDI and Export-platform Production

A number of developing countries have used FDI to exploit the resources of MNEs such as globally recognized brand names, best practice technology or by getting integrated with their global production networks, among others, for expanding their manufactured exports. In the case of China, for instance, 55 per cent of its manufactured exports are undertaken by foreign invested enterprises, which account for as much as 80 per cent of all technology intensive exports (UNCTAD 2005). Foreign enterprises while setting up export-oriented production bases had created 23 million jobs by 2003 making China a global factory. The literature also finds the role of export-oriented FDI in bringing world's best practice technology as the affiliate has to compete globally right from the beginning. It also enhances the chances of FDI inflows crowding in of domestic investment and reducing the chances of crowd-out as the foreign affiliate would be mainly catering to the outside markets rather than eating into domestic firms' markets. It would also create fresh possibilities of market information spillovers for domestics firms on export possibilities.

Unlike the East Asian countries, South Asian countries have generally not been able to exploit the potential of FDI for export-oriented production except for some export-oriented plants set up by MNEs in Sri Lanka, India, Bangladesh and other countries. The bulk of FDI inflows in these countries are market seeking. This may be changing however as recent studies of export-performance are beginning to indicate a relatively superior performance of foreign

enterprises in terms of export orientation unlike early studies (see Kumar and Joseph 2007, for recent analysis and Kumar and Siddharthan 1994, and Sharma 2000, for earlier findings).

R&D and Other Knowledge-based Activities and Local Technological Capability

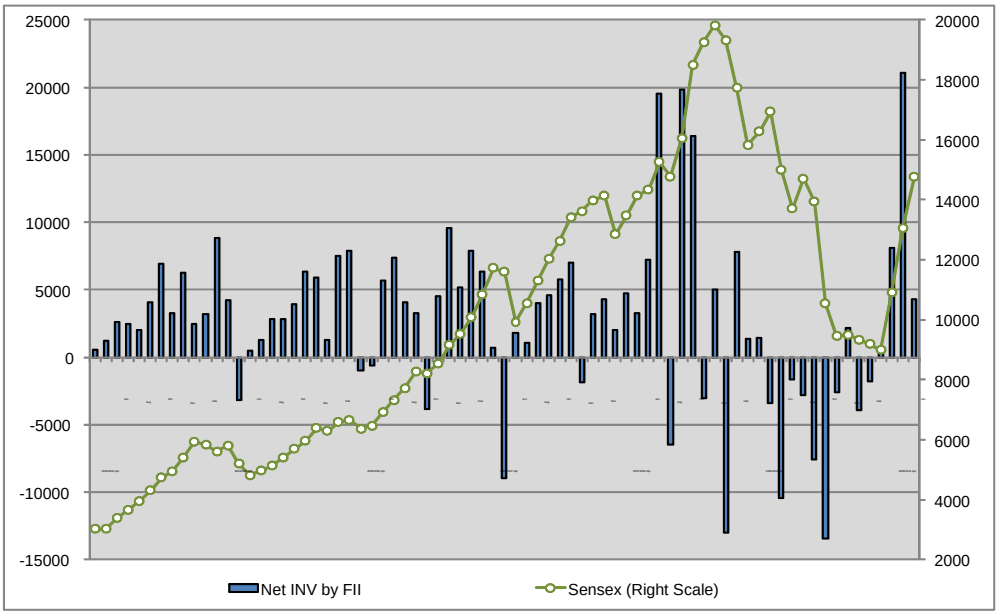
A comparison of R&D intensity of foreign firms and local firms has not been possible due to lack of data for other South Asian countries. In India's case foreign firms appear to be spending more on R&D activity than local firms although gap between their R&D intensities has tended to narrow down. A study analyzing the R&D activity of Indian manufacturing enterprises in the context of liberalization has found that after controlling for extraneous factors, MNE affiliates reveal a lower R&D intensity compared to local firms, presumably on account of their captive access to the laboratories of their parents and associated companies. The study also observed differences in the nature or motivation of R&D activity of foreign and local firms. Local firms seem to be directing their R&D activity towards absorption of imported knowledge and to provide a backup to their outward expansion. MNE affiliates, on the other hand, either focus on customization of their parents' technology for the local market (Kumar and Agarwal 2005). Most important determinant for attracting R&D investments (and other knowledge based activities such as software development activity) by MNEs has been the cumulative investments made by governments in what is known as national innovations system. These include resources in development of a system of higher education in engineering and technical disciplines, creation of an institutional infrastructure for S&T policy making and implementation, building centres of excellence and numerous other institutions for technology development, among other initiatives (Kumar 2001).

4.2 Impact of portfolio foreign investments

India's exposure to inflows from foreign institutional investors has increased in the last few years, given the good performance of the stock markets as the economy gathered growth momentum. In the year 2007-08 India had a net inflow of $20 billion of FIIs. This sizeable inflow on the Indian bourses led to not only stock prices booming with BSE Sensex more than doubling from under 10,000 to 20,000, but also the exchange rate of rupee going up from 47 Rupees to a dollar to 38 Rupees to a dollar. The sharp appreciation of rupee by itself was an external shock of sorts adversely affecting Indian exports and calling for a response by the government. In 2008-09, apparently due to the financial crisis in the western world, there was a net outflow of FIIs to the tune of $15 billion dollars. The levels of outflow of resources were large even for an economy of India's size and expectedly brought down the stock markets from nearly 20,000 points of BSE Sensex to less than 9000 points in the early part of 2009. Much more importantly it has led to a sharp depreciation of rupee by nearly 25 per cent in early 2009. The depreciation would have been more if the Reserve Bank of India had not intervened in the market by selling dollars. In this process of net outflows of FIIs and selling of dollars to protect rupee from going down further, the foreign exchange reserves from 2007-08 to 2008-09 have depleted by $58 billion to about $252 billion from $310 billion. However as the FIIs returned to the market with the onset of recovery and the FII inflows to the country in 2010 are expected to be of the order of $ 20 billion bringing the Sensex to cross 20,000 point in October 2010. Despite RBI's market intervention, the rupee has appreciated by nearly 8 per cent and foreign exchange reserves have been augmented to about $284 billion.

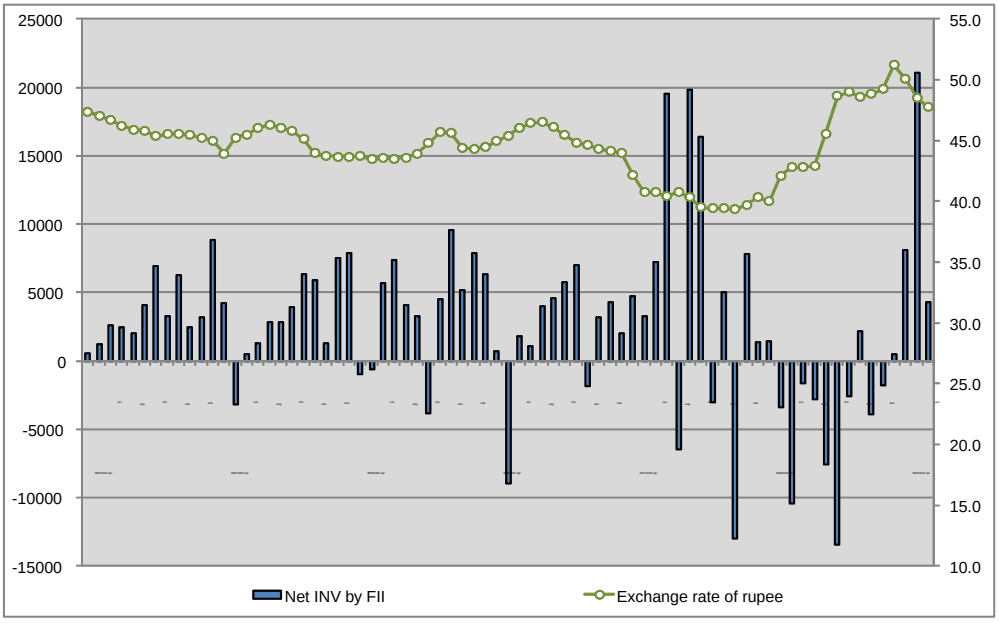
As is clear from Figures 4 and 5, FPI inflows have become primary determinants of the movements in the stock exchange indices and the exchange rate of the rupee. As there are sharp movements in these inflows linked to global developments, they become channels of transmission of instability to the country's financial system. As a result, the rupee has been on a roller coaster ride: from Rs 44 per dollar in January 2007 to Rs 39 in January 2008 to increase again to Rs 49 per dollar in January 2009 to Rs 44 in October 2010. Such wild variation in exchange rate can be highly disruptive for the economy in general and industry in particular, implying a constant adjustment by the latter to the fluctuations. In case the appreciation is of a structural nature resulting from sustained trade surplus, it could be self correcting. However, in India's case there is a situation of widening trade deficit combined with appreciation of rupee as observed in 2007/08, and in 2010/11.

Figure 4. FII Inflows and BSE Sensex



Source: updated from Kumar (2009); data source: RBI's database (2010).

Figure 5. FII Inflows and the Exchange Rate of Rupee



Source: updated from Kumar (2009); data source RBI's database (2010).

Besides the instability, the servicing cost of FII inflows is very high. Among foreign resources such as FDI, foreign borrowings, NRI deposits, ADRs/GDRs, the FII investments are most expensive in terms of servicing burden. This is because they come to chase primarily good returns at the stock markets and exchange rate speculation. In 2007-08, Indian stock markets were giving around 44% return. That means for every dollar India received in FII flows, it became liable to pay $1.44 in one year. One may argue that these flows help a country to build foreign exchange reserves. What is not appreciated very well is the fact that exposure to these inflows also enhances the need to have large foreign exchange reserves due to their highly volatile nature. Therefore, developing countries such as the South Asian countries should rely for their foreign resource needs more on FDI inflows and where possible raise ADRs/GDRs and deposits from nonresident nationals rather than relying on the FIIs. In view of their high cost and their other deleterious effects such as instability, a number of emerging economies such as Brazil, South Korea, and Indonesia have recently imposed capital controls to moderate their volatility. The unprecedented injection of liquidity by the governments in developed countries in the wake of global financial crisis is likely to find its way to emerging economies of Asia to take advantage of higher returns. There is now a growing consensus on the relevance of capital controls as aspects of the policy tool kit for the governments in emerging economies (UN-ESCAP 2010, Ostry et al 2010). The benefits of maintaining open capital accounts, if any, are ambiguous.

5. Concluding remarks and policy lessons

The above discussion has reviewed the performance of South Asia in terms of its attractiveness for FDI and FPI inflows. These inflows to South Asia have grown in the recent years in response to policy liberalization and their robust economic performance. Although starting from a low base, South Asian countries have also been able to increase their share in

FDI inflows received by developing countries especially in the past few years and are catching up with Southeast Asian countries in terms of share of these inflows in capital formation. The region is yet to realize the potential of intra-regional FDI inflows even with their emergence as sources of outward FDI. South Asia especially India is also attracting large magnitudes of portfolio equity flows from foreign institutional investors (FIIs) which are highly volatile.

The above discussion also shows that even though South Asian countries may be attracting increasing magnitudes of FDI inflows, they are yet to harness their development potential fully. The empirical studies suggest that the region has received FDI inflows of mixed quality and the developmental impact has been uneven. They can learn a great deal from the experiences of China and other Southeast Asian countries in this regard. China has had a much greater success in harnessing the potential of FDI for building high technology export-oriented industrial base using a variety of policy instruments and performance requirements. On the other hand, the region especially India is getting exposed in a significant manner to the FPI flows that are not only highly volatile and are expensive in terms of servicing burden.

Policy Lessons

In general, the above analysis brings out the role of government policy in attracting and benefiting from FDI inflows for development. In light of this discussion we may now draw a few policy lessons for the region and other similarly placed developing countries.

First of all, liberalization of FDI policy may be necessary but not sufficient for expanding FDI inflows. The overall macroeconomic performance continues to exercise a major influence on the magnitude of FDI inflows by acting as a signalling device for foreign investors about the growth prospects for the potential host economy. Hence, paying attention to macroeconomic performance indicators such as growth rates of industry through public investments in socio-economic infrastructure and other supportive policies and creating a stable and enabling environment would crowd-in FDI inflows. Studies have shown that policies that facilitate domestic investments also pull in FDI inflows. While investment incentives may not be efficient, active promotion of FDI by developing certain viable projects and getting key MNEs interested in them could be useful in attracting investments in desirable directions.

The evidence suggests that the government policies play an important role in determining the quality or developmental impact of FDI and in facilitating the exploitation of its potential benefits by host country's development. The various performance requirements such as phased manufacturing programmes, export performance requirements and domestic ownership requirements have also been employed by the governments to achieve their developmental policy objectives. Even with liberalized policy some policy direction to FDI is desirable as has been demonstrated by the case of East Asian countries.

One way to maximize the contribution of FDI to the host development is to improve chances of FDI crowding-in domestic investments and minimize the possibilities of it crowd-out domestic investments. In this context, the experiences of Southeast Asian countries such as Malaysia, Korea, China, Thailand in channeling FDI into export-oriented manufacturing through selective policies and export performance requirements imposed at the time of entry deserve careful consideration (see Kumar 2005b for evidence). The export-oriented FDI minimizes the possibilities of crowding-out of domestic investments and generates favourable spillovers for domestic investments by creating demand for intermediate goods. Another

policy that can help in maximizing the contribution of FDI inflows is to push them to newer areas where local capabilities do not exist as that minimizes the chances of conflict with domestic investments. Some governments such as Malaysia have employed pioneer industry programmes to attract FDI in industries that have the potential to generate more favourable externalities for domestic investment (see UNCTAD 1999, 2001, for examples). Similarly because MNE entry through acquisition of domestic enterprises is likely to generate less favourable externalities for domestic investment than greenfield investments, some governments discourage acquisitions by foreign enterprises (see Agosin and Mayor 2000, for examples).

Another sphere where governmental intervention may be required to maximize gains from globalization is in diffusion of knowledge brought in by foreign enterprises. An important channel of diffusion of knowledge brought in by MNEs in the host economy is vertical inter-firm linkages with domestic enterprises. Many governments –in developed as well as developing countries alike- have imposed local content requirements on MNEs to intensify generation of local linkages and transfer of technology (see Kumar 2005b for evidence). The host governments could also consider employing proactive measures that encourage foreign and local firms to deepen their local content as a number of countries, e.g. Singapore, Taiwan, Korea and Ireland have done so successfully (see Battat, et al. 1996). The knowledge diffusion could also be accomplished by creating sub-national or sub-regional clusters of inter-related activities which facilitate the spillovers of knowledge through informal and social contacts among the employees besides traditional buyer-seller links. UNCTAD (2001) also highlights the policy measures employed by different governments in promoting linkages.

Investments made by governments in building local capabilities for higher education and training in technical disciplines, centers of excellence and in other aspects of national innovation systems have substantial favourable externalities as is demonstrated by the case study of FDI in India’s knowledge-based industries (Kumar 2005a).

Finally, in view of the instability of exchange rates and capital markets brought about by short term capital flows by FIIs, adoption of capital controls may be considered to moderate their volatility.

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