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Intra-Regional FDI and Economic Integration in South Asia: Trends, Patterns and Prospects

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Abstract

This paper examines trends and patterns of intra-regional FDI in South Asia, with a focus on the potential for integrating production processes among countries in the region through further trade and investment policy reforms. The empirical evidence pieced together from scattered sources suggests that horizontal (market seeking) FDI has continued to dominate South Asian intra-regional FDI, with a significant shift in recent years in favour of services sector activities. Vertical (efficiency seeking) FDI in the region has remained confined to a few product lines, predominately garments, and also a few industries in which the availability of specific natural resources plays an important role in the site selection decisions of firms. In other industries, including electronics and electrical goods in which global production sharing is heavily concentrated, there is no evidence of notable cross-border operations by regional firms. The limited achievement so far in fostering cross-border production sharing through vertical FDI has been the outcome of unilateral, rather than region-wide, trade and investment policy reforms.

Key word: South Asia, foreign direct investment, regional economic integration, production networks

JEL Codes: F21, F23, F53, O33

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Intra-Regional FDI and Economic Integration in South Asia: Trends, Patterns and Prospects¹

1. Introduction

South Asia is unique among the major geographic regions in the world for its low level of intra-regional trade.² The conventional wisdom based on the standard trade theory holds that there is little room for fostering intra-regional trade in the region through collective action given the similarities among these countries in terms of resource endowments. However, the proponents of regional economic integration argue that the existing patterns of production and trade should not be treated as a guide to policy because there is ample room for creating economic complementarities through further trade and investment policy reforms. By referring to the on-going process of global production sharing (international production fragmentation) and giving examples from the experiences of the East Asian economies in reaping gains from this new form of international exchange, they argue that there is potential for integrating production processes among countries by promoting vertical (efficiency seeking) foreign direct investment (Dosani 2010, RIS 2008).

The purpose of this paper is to contribute to this debate by examining emerging trends and patterns of intra-regional FDI in South Asia. There is a sizeable literature on regional economic integration initiatives and intra-regional trade in the region.³ However, to our

¹ This paper draws on research undertaken for UNCTAD, Geneva. The author would like to thank Rashmi Banga and Richard Kozul-Wright for sponsoring the study. He would also like to thank Ramesh Paudel for excellent research assistance and to Swarnim Wagle¹ for his inputs to the discussion in the paper on FDI policy regimes in South Asian countries.

² During 2009-11 the share of intra-regional trade in total world trade of the member countries of SAARC (the South Asian Association for Regional Corporation) was 5.2%, compared to ASEAN (the Association of Southeast Asian Nation): 26.5; COMSEA (the Common Market for Easters and South Africa): 22.3%; and MERCOSUR (the Southern Common Market): 20.5 (calculated from UN COMTRADE database).

³ Chapters in Srinivasan (ed.) 2002 and Dosani et al (ed.) (2010) provide a comprehensive coverage of this literature.

knowledge, intra-regional FDI and the FDI-trade nexus have not, so far, been studied from a comparative, region-wide perspective. The paper is exploratory in nature; its scope and the depth of analysis are constrained by the nature of data availability.

The paper is structured as follows: Section 2 provides an analytical framework to help delineate the potential channels through which regional economic integration initiatives could affect FDI and trade flows. Section 3 presents a comparative overview of trade and investment policy reforms in the region. Section 4 surveys trends and patterns of regional foreign direct investment in individual countries in the region, followed by a synthesis of the salient features of intra-regional FDI against the back drop of changing patterns of total regional inward and outward FDI. The key findings and inferences are summarized in the concluding section.

2. Regional Integration, Trade and FDI: An Analytical Framework

Regional economic integration is expected to promote FDI through reduction in trade cost⁴, market enlargement and improving policy credibility. For the purpose of analysing the impact of regional economic integration on the FDI-trade nexus, it is important to distinguish between horizontal (or market-seeking) FDI (HFDI) and vertical (efficiency-seeking) (VFDI). HFDI takes place when a multinational enterprise (MNE) produces the same goods (and services) in order to avoid trade costs of exporting goods from one country another, while retaining its firm specific advantages in production. By contrast, VFDI takes place when a MNE geographically fragment the production process (value chain) of a given product into stages, in order to take advantage of location-specific advantages such as lower factor prices and the quality of trade-related logistics. Thus, VFDI is more likely to occur in industries with production processes that can be easily fragmented into several stages characterised by different factor intensities and between countries with different factor endowments. In each case, the MNE faces trade-offs in its investment decision: avoiding trade cost through HFDI implies foregoing economies of scale, as production is distributed across several plants located in different host countries, whereas VFDI involves costs of

⁴ The term 'trade cost' is used here in a broader sense to encompass all costs that are incurred in conducting international trade and include transport costs, tariffs, and other transaction costs.

coordinating fragmented activities in several locations ('service link cost', *a la* Jones and Kierzkowski 2000). Some of the factors that are important in these trade-offs are firm or industry specific (e.g. the importance of economies of scale), and some depends on country characteristics such as market size, factor price differences, and various aspect of the trade and investment policy regimes. VFDI is predicted to occur when factor cost savings are large relative to the costs of coordinating fragmented activities in several locations (Navareti and Venables 2005).

In the context of regional economic integration, HFDI can take two forms, tariff-jumping investment or investment triggered purely by tariff preferences, and investment driven by the market enlargement effect. Tariff-jumping investment would contribute to trade diversion, shifting the location of production from a low-cost source of supply outside the region to a higher-cost source in a member country. The attractiveness of the region for tariff-jumping investment depends on the magnitude of the "margin of preference", the difference between the preference tariff among the member countries and the tariff applicable to trade with third parties. Differences in members' tariffs may be important in procuring low-cost imported inputs, which could influence the location of investment in relatively low tariff countries in the region from third countries as well as from high tariff countries within the region. This influence would be magnified if there are significant differences among member countries in non-tariff barriers to third country trade. In the early literature on the investment effect of regional economic integrations, it was generally believed that, apart from the contemporaneous influence of the existing (initial) preference margins, the formation of a regional trading agreement (RTA) can impact on investment decisions of the tariff-jumping variety by creating a (perceived or real) threat of protection for extra-regional trade. The simple point here was that the creation of a wider regional market may foster a more protectionist approach towards extra-regional trade.⁵ However, this postulate is of limited relevance for analysing the investment effects of modern RTAs because most (if not all) partners to RTAs pursue regional trade liberalisation as an integral part of their commitment to unilateral and multilateral (WTO-based) trade liberalisation.

⁵ There is, in fact, evidence that one of the principal factors behind the massive increase FDI inflows to countries in the EC since the late 1980s was the concern that the single market would be heavily protectionist: that the existing structure of protection with national quotas would give way to EC-wide quotas and a tougher trade regime (Balasubramanyam and Greenaway 1993, p. 157).

HFDI driven by the market enlargement effect has the potential to promote intra-regional trade. The removal of tariff barriers on intra-regional trade leads to an increase in the size of the “domestic” market, enabling plants that are large enough to exploit economies of scale to be built. The market enlargement effect would be greater if the member nations have similar income levels and demand structures, but diverse preferences for varieties of goods (a condition which is generally met by developed, rather than developing, countries). The formation of a RTA could allow producers to “exchange” scale economies in the provision of differentiated goods. In an enlarged market, economies of scale may be achieved through the construction of large plants that produce a single product (economies of scale in the traditional sense), through the reduction in the number of product varieties in individual plants (horizontal specialisation), and through the manufacture of parts, components, and accessories of a particular product in separate locations (vertical specialisation). The first type of scale economy is particularly important in heavy industry, such as steel, chemicals, petroleum refining and pulp and paper.

From about the late 1960s, VFDI has shown phenomenal growth as an integral part of the on-going process of global production sharing (international production fragmentation) (Jones and Kierzkowski 2001, Feenstra 2011, Athukorala 2007). This phenomenon has been the outcome of the growing ability of modern industry to ‘slice up the value chain’ of goods traditionally viewed as skill-, capital- or technology-intensive and shift the labour-intensive slices to low-wage locations. Assembly activities related to electronic industries, assembly of semi-conductor devices in particular, are by far the most important. The other industries with significant assembly operations located in developing countries are electrical appliances, automotive parts, electrical machinery and optical products. However, there is evidence from recent studies of trade patterns of standard light manufactured goods such as clothing, footwear and wood products that, even in these industries, there are growing opportunities for countries to specialise in different tasks within the global value chain (such as designing, providing technical and managerial expertise, producing accessories, marketing/distribution), rather than producing the good from start to finish within its own national borders (Gereffi *et al.* 2005, Tewari 2006 & 2008).

It is generally believed that RTAs among developing countries (South-South RIAs) are unlikely to have significant impact on intra-regional VFDI flows. This effect depends on members having complementary economic structures (dissimilar patterns of production) which provide scope

for intra-industry specialisation. If the members of the RTA are very similar in terms of factor endowments (e.g. their greatest resource is their large labour force), the scope for the relocation of production processes among countries based on “true” competitiveness will not be large (Ethier 1998). Compared to RTAs among developing countries, those involving both developed and developing countries (such as NAFTA and the enlarged EU) are, therefore, likely to have a greater impact on FDI rather than will RIAs involving only developing countries.

However, even in the case of South-South economic integration, one can still expect VFDI to occur depending on differences among the member countries in terms of stage of development, even though such differences do not appear significant in the standard developed-developing country comparison. The geographical proximity among member countries, combined with such differences, could play a role in facilitating the restructuring of production across countries. Geographical proximity reduces transaction costs associated with transportation and communication (Schiff and Winters 2003). Moreover, the country-specific advantages required for vertical specialisations such as the skill-composition of the labour force, entrepreneurial talents, the quality of trade-related logistics are not static but endogenous to the reforms process. Also, firms have the potential to develop their own specific ‘assets’ (firm characteristics) required for success in vertical specialisation through their exposure to foreign competition and links forged with foreign buyers (Alvarez 2007).

3. Policy Context

From the inception of their independent nationhood and well into the 1970s, countries in South Asia pursued import substitution (IS) — the promotion of industries oriented toward the domestic market by using import restrictions, or even import prohibition, to encourage the replacement of imported manufactures by domestic products — as the central tenet of the national development strategy. During the import-substitution era these countries were not very receptive, if not completely hostile, to foreign direct investment. They did not rule out FDI, but wanted it on their own terms. The regulatory mechanism governing the entry of MNEs was characterised by an explicit preference for technical collaboration agreements as opposed to FDI; a policy stance dictated by the desire to achieve the (conflicting) twin objectives of minimising

foreign control on business operation and gaining access to foreign technology. Foreign investment applications were generally considered on a case-by-case basis and that too favouring majority local ownership. From about the late 1960s, countries in the region began to encourage export-oriented FDI by offering tax incentives and, in some cases, full foreign ownership. Naturally, these policies had little success given the anti-export bias in the overall incentive structure.

In all South Asian countries, policy regimes relating to the approval and monitoring of outward FDI were even more restrictive compared to their trade policy regimes. In India, the only country in the region that had some local firms with capacity to venture overseas, government policy towards overseas investment was formulated on the basis of the foreign exchange earning capacity of proposed ventures. As part of the highly restrictive foreign exchange monitoring process, every proposal had to be placed before an inter-ministerial committee on joint venture for approval. Overseas investment was normally permitted only in minority-owned joint ventures. As regards financing of the proposed project, the government severely restricted cash remittances for equity participation and encouraged the export of capital equipment and technology from India for the purpose. It was stipulated that 50% of declared dividends should be repatriated to India. All project proposals were screened on a case-by-case basis, approving only those that promised quick payoffs in the form of exports (Lall 1986).

In the 1960s and 1970s there were some episodes of partial trade and investment policy reforms in these countries, but they were rather short-lived. Sri Lanka led the way in breaking away from the protectionist past, by embarking on a decisive process of economic opening in 1977. The other countries embarked on significant liberalisation reforms from the late 1980s. Bangladesh introduced moderate tariff cuts and some relaxation of quantitative restrictions (QRs) on imports in 1980, followed by further reforms in 1984 and in the early 1990. By the mid-1990s, the import licensing and QRs had been virtually eliminated accompanied by a significant reduction in tariffs. Bhutan embarked on trade policy reforms in the early 1990s as part of a structural adjustment reform package. Over the past two decades, more than 80% of Bhutan's has been carried out under free trade agreements signed with India and Bangladesh. India implemented a series of partial trade liberalisation in the early 1980s, but followed a tortuous route throughout the decade. The reform process, however, gathered momentum in the

early 1990s, following a massive balance of payment crisis in 1991, which severely constrained its ability to continue with past policies. The Maldives began trade liberalisation reforms in 1989 and reforms implemented during the ensuing five years made it eligible for accession to the WTO membership in 2005. Nepal began to lift trade barriers gradually in the mid-1980s and expedited the reform process in the 1990s as part of the process leading to becoming a WTO member in 2004. Pakistan has a chequered history of trade liberalisation. It embarked on liberalisation reforms in the early 1960s, but the reform process was hampered by political turmoil in the ensuing two decades. However, there has been substantial tariff reductions and dismantling of QRs in the late 1980s.

While there are vast inter-country differences in terms of the degree of liberalisation achieved during the ensuing years and comprehensiveness of reforms, by the mid-1990s all these countries seemed to have moved into a seemingly irreversible process of economic liberalisation (Table 1). Market friendly reforms sustained over three decades have brought about a high degree of commonality relating to the trade policy regimes among these countries. Tariff levels have come down. All South Asian countries other than Bhutan, had achieved IMF Article VIII status for current account liberalisation by the turn of the last century. In addition to trade liberalisation, South Asian countries have substantially removed behind-the-border restrictions on operations of the private sector. They have also unified their earlier system of dual or multiple exchange rate systems and allowed market forces to play a greater role, albeit at varying degrees, in determining exchange rates.

Table 1 about here

Table 2 about here

As part of liberalisation reforms all countries in the region have become more receptive to FDI. Sri Lanka is unique in the region for concurrent liberalisation of trade and investment policy regimes (Athukorala and Rajapatirana 2000). In other countries, investment liberalisation followed trade liberalisation with a substantial time lag. In addition to FDI liberalisation, a range of measures have been introduced by all countries to entice FDI. These include procedural simplifications, increasing caps on equity participation, and bringing more sectors under

automatic approval, various financial incentives, relaxing restrictions on repatriation of profits and capital, fast tracking of FDI approvals, guarantees against nationalisation and expropriation, and signing investment protection agreements with source countries of FDI. Key features of the investment policy regimes are summarized in Table 2.

Despite recent reforms, India's foreign investment regime still reflects the tension between the traditional aversion to foreign investment and the current recognition of its importance to economic development (World Bank, 2010). For example, FDI is still not permitted in pure retailing; global retailers can only participate in India's retail sector through wholesale trade or by operating retail outlets through local franchises. In apparel and other light consumer-good producing industries, which are important in export expansion and job creation at the current stage of economic development of the country, FDI is limited to 24% of total equity. Restrictions on foreign ownership of land limit the entry of foreign builders and developers into the construction sector. Projects with 51% or more foreign ownership still require a long procedure of government approval. There are also many unresolved problems relating to the overall investment climate. While 'the License Raj' (the infamous industrial licensing policy) has been largely eliminated at the centre, it still survives at the state level, along with a pervasive 'Inspector Raj'.

Policies relating to outward FDI too have become more liberal in all countries, although they still remain more restrictive compared to those applicable to inward FDI. In India, relaxation of restrictions on overseas investment began in 1992. The first step was to introduce an automatic route for overseas investment up to US\$4 million. The authority for approval of proposals up to US\$15 million was vested with the Reserve bank of India (RBI), but proposals more than US\$15million still had to be approved by the Minister of Finance. In 2002 the upper limit for automatic approval was raised to US\$100 million per annum, of which 50% could be obtained from any authorised dealer of foreign exchange. In 2004, firms were allowed to invest up to 100% of their net worth under the automatic route. In 2005 this limit was raised to 200% of net worth and prior approval from the RBI was dispensed with and firms were permitted transferring funds through any authorised foreign exchange dealer. Indian firms' access to international financial markets was also progressively liberalised and they were permitted to the

use of special-purpose vehicles in international capital markets to finance acquisitions abroad (FICCI 2006).

Trade opening in all South Asian countries has largely taken the form of across-the board liberalisation, both unilaterally and as part of the liberalisation commitments under the WTO. But, they have also embraced the new-found global enthusiasm for preferential (regional and bilateral) liberalisation over the past two decades. The seven South Asian countries (Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka) signed the SAARC⁶ Preferential Trading Agreement (SAPTA) in 1993. SAPTA became operational in 1995 when the first round of tariff concessions was exchanged. After 1995, two more rounds of tariff cuts were completed and a fourth round in progress was interrupted by the military coup in Pakistan in 1999. However, the tariff concessions exchanged during the three rounds have hardly made any impact on trade integration within the region. Some of the most important sectors of trade were left out in the commodity-by-commodity negotiation process. Some of the tariff concessions offered were on products which were not even traded among the countries. More importantly, not even a beginning was made towards the removal of non-tariff barriers (Dubey 2010, Kelegama and Mukherji 2008).

In 2006 the South Asian Free Trade Area (SAFTA) superseded SAPTA. Article 7 of the SAFTA provides for a two-stage tariff reduction program to reduce all tariffs to 5% or below by the three NLDC member countries (India, Pakistan and Sri Lanka) by 2015 and NLDC member countries by 2018.⁷ So far there has been little progress in the implementing of the proposed tariff reduction program. Even if fully implemented, it is unlikely to bring about 'free trade' in the region: all countries have opted to retain a long list of "sensitive" products with a view to

⁶ These countries formed the South Asian Association for Regional Cooperation (SAARC) in 1985. But, for the first decade SAARC was largely engaged in confidence building and public relations campaigns designed to impress domestic audience and foreign powers.

⁷ Under SAFTA, India, Pakistan and Sri Lanka are categorized as Non-Least Developed Contracting States (NLDCS) and Bangladesh, Bhutan, Maldives, Afghanistan and Nepal are categorized as Least Developed Contracting States (LDCS). According to Article 14, the NLDCs and LDCs would bring down tariffs to 20% and 30% within the first three years. This would be followed by a further reduction of tariff by NLDCs to the 'free-trade level' (0-5%) within 5 years and LDCs within 8 years.

protecting particular economic sectors against exemption of duties under SAFTA and nearly 53% of current intra-SAARC imports are currently restricted under the sensitive list. India's sensitive list is more than three times as large as the one it offered in the last round of negotiations for an FTA with ASEAN. A variety of nontariff barriers (NTBs) also continues to frustrate trade. Pakistan has decided not to extend its obligations under the agreement to its trade with India, excluding potentially the largest segment of regional trade from the SAFTA process (Dubey 2010). Some countries have implemented 'para-tariffs'⁸ which have virtually counterbalanced the limited tariff preferences offered under the SAFTA (Pursell 2011).

A major qualitative change in regional economic integration initiatives in other parts of the world over the past two decade has been the recognition that effective integration requires more than simply reducing tariffs and quotas (Schiff and Winters 2003, 7-9). It is widely believed that, many other types of barriers have the effect of segmenting markets and impeding the free flow of goods, services, investment and ideas, and wide-ranging policy measures- going well beyond international trade policies – are needed to remove them ('deep integration'). In particular, promoting investment is a prominent objective of many regional integration agreements. However, SAFTA does not cover liberalisation of investment: it only *list* this in Article 8 under the title 'Additional Measures'.

The report of the Group of Eminent Persons (GEP), which was set up by SAARC in 1997 to draw a road map for the implementation of SAFTA, recommended the creation of a Common Investment Area under SAARC. Based on this recommendation, India came up with a draft investment agreement for permitting freer flow of intraregional investment in the region (RIS 2008). The proposal included measures to remove administrative and regulatory constraints on the flow of investment among SAARC countries, to exchange information on possibilities for investment, and promote investment from other regional countries. An agreement for the establishment a SAARC Arbitration Council, as a prelude to negotiating an investment agreement based on the Indian draft, was signed by the SAARC member countries on July 2, 2007, but so far no further progress has been made.

⁸ Various levies and taxes which do not come under the SAFTA definition of tariffs

The slow progress of the SAPTA process has led to attempts by some member countries to pursue a 'fast-track' liberalisation of trade through bilateral free trade agreements (FTAs). Currently there are three bilateral FTAs in the region: India-Bhutan, India-Sri Lanka and Pakistan-Sri Lanka. And four FTAs are under negotiation: India-Pakistan, India-Bangladesh, Pakistan-Bangladesh and Sri Lanka-Maldives.

Under the ISLFTA, which became operational on 1 March, 2000, Sri Lanka and India have achieved a much higher degree of trade liberalization on a bilateral basis than had achieved under the SAFTA. For instance less than 14% of Sri Lanka's exports are covered by the India's sensitive list under the ISLFTA, compared to nearly 42% under India's SAFTA sensitive list. So far 4150 Indian tariff lines have been made zero duty for Sri Lankan exports to India and 3932 tariff lines for Indian exports to Sri Lanka. Motivated by the positive outcome of the ISLFTA, in 2002 the governments of India and Sri Lanka agreed to explore the option of converting LBBFA into an India-Sri Lanka Comprehensive Economic Partnership Agreement (ILCEPA) modelled after the India-Singapore CEPA which covers both trade and investment. Fourteen rounds of negotiations have been completed, the last round having been held in Colombo in December 2010.

Pakistan-Sri Lanka FTA (PSLFTA) was signed in July 2002 and came into operation on June 12, 2005. At the time of negotiating the FTA there was hope that it will help Sri Lanka to acquire 'hub state' in Pakistan-India trade. Given the prevailing prohibition on formal cross-border trade between India and Pakistan (see below), it was expected that Sri Lanka would be able to promote Indo-Pakistan trade by encouraging Pakistan investors to open operations in Sri Lanka in order to trade with India using ISBFTA.

Both Nepal and Bhutan have long-standing trade treaties with India. In 1996 India and Bhutan also signed a FTA. India has a firm commitment to maintain smooth trade and investment links with these countries because of their geographical position; both countries are viewed by India as part of its security frontier with China (Lama 2010).

In addition to the remaining tariffs and quantitative trade restrictions, restriction on cross-border transport remains a major barrier to trade and cross-border investment in the region. India does not permit transit facilities for the movement of Pakistani goods or persons through its

territory. Bangladesh continues to deny transit facilities through its territories for the movement of India's goods or persons to other parts of India. These restrictions add huge costs to trade between the two countries. For instance it takes 45 days transport a container from Delhi to Dhaka; if overland railway transport were permitted by Bangladesh, it would take only 2 to 3 days. Currently, trade between Pakistan and India takes place mostly via Singapore or Dubai. The landlocked countries of Bhutan and Nepal can make large savings in transporting their goods to destinations outside the region if India would allow transit facilities so that their goods could reach ports in Bangladesh (Sobhan 2010).

4. Intra-Regional FDI in South Asia

This section begins with a county-by-country discussion of intra-regional FDI in South Asian countries in the context of overall FDI in these countries. This is followed by a comparative analysis aimed at identifying broader, region-wide trends and patterns of FDI.

India

In Indian FDI approval data, intra-regional FDI inflows are lumped together under the catch-all residual category of 'other countries'. This catch-all category has accounted for around 1.5% of total value of approved investment during 2000-2011. Aggarwal (2008) has compiled data on intra-regional inward FDI from unpublished approval records of the Secretariat of Foreign Investment (SFI), Ministry of Finance. 1998-2007. According to her data tabulations, during 1998-07, Indian government had approved 55 intra-regional projects. Sri Lanka is the largest regional investor (45 projects), with Bangladesh (6) and Maldives (4) accounting for the balance. As already noted, from the time of separation in 1947 until 1 September 2012, there was a complete ban on Pakistani investment in India.

Bangladeshi and Maldivian ventures in India are in trade and distribution sectors. The Sri Lankan firms are in a wide range of activities, with textile and garments dominating the product mix. During the past decade a number of clothing producers in Sri Lanka, including the two largest producers in the country, MAS Holdings and Brandix, have set up production bases

in India. These companies are expanding their operations in India based on the firm-specific advantages accumulated over three decades of their successful operations in the Sri Lanka in the context of market-oriented policy reforms initiated in the late 1970s. The Indian operations are a strategic move to gain both scale economies by accessing the vast Indian market and to reaping cost advantages in global apparel markets by exploiting India's vast unexploited potential for integrating domestic textile production within the global apparel value chain. Both companies have plans to expand operations in India, using Sri Lanka as the regional hub for product design and development, sourcing clothing accessories and top-end apparel production.

MAS and Brandix are family-based Sri Lanka companies with historical roots in textile trade in the country dating back to the colonial era.⁹ Following the trade-cum-investment liberalisation reforms initiated in the late 1970s, a large number of East Asian clothing producers (mostly from Hong Kong) set up production plants in the country. The founders of MAS and Brandix ventured into export-oriented clothing industry through links forged with the international buyers who came to Sri Lanka following the footsteps of these clothing producers. As the links with foreign buyers became firmly established based on timely delivery and meeting quality standards, the two humble, made-to-order clothing firms rapidly evolved to become groups of companies engaged in the production of fabric, apparel accessories (hangers and elastic etc), product design and development, wet-processing and finishing, and trade-related logistics in the clothing value chain. A number of foreign firms, which initially supplied fabric and clothing accessories to MAS and Brandix, have set up backwardly-linked production bases in Sri Lanka.

The MAS group of companies, which has grown on the basis of a long standing strategic partnership with Victoria's Secret, is now the largest producers of lingerie (women's intimate wear) in South Asia. Casualwear forms the core of the Brandix group of companies, but it has also ventured into production of lingerie and sportswear over the past two decades. The two groups of companies are now well-established suppliers to a number of brand-name owners such as Victoria's Secret, Marks & Spence, Nike, Speedo, Triumph, La Senza, GAP, DRA, H&M, Lululemon, Oysho and Athleta. MAS has set up production facilities India, China, Indonesia

⁹ The MAS-Brandix story in this section is based on Abeyratne and Karunaratne (2013), MAS (2007), INSEAD (2006), Wijesiri and Ekanayake (2008), and material from the websites of the two companies,

and Mexico. Brandix has a large casualwear production plants in Bangladesh, and a trading company (Brandix Asia) in Hong Kong. Brandix Asia acts as the overseas trading arm for the Brandix group of companies. MAS employ over 50,000 workers and Bandix over 35,000 in their Sri Lankan operations alone.

In 2006, Brandix started developing a 1000 acre vertically integrated textile and garment park ('Brandix India Apparel City', BIAC) in the port city of Vishakapatnam in India's Andhra Pradesh state. It was formally inaugurated in 2010. With an initial investment of US\$750 million, BIAC is so far the biggest foreign investment in clothing industry in India. At full capacity, it expects to generate a turnover of US\$1.2 billion and employ over 60,000. Brandix Apparel Ltd, the Sri Lanka based trading and sourcing arm of all apparel manufacturing entities of the Brandix Group, is the first enterprise to start operation in BIAC. It currently employs 1600 workers and has begun to supply fabric from the Indian base to Brandix apparel firms in Sri Lanka and Bangladesh. A number of other world-class companies involved in various layers of the global apparel supply chain (ranging from spinning, knitting and weaving, clothing accessories, apparel making and embellishment, store services and logistic) have either already set up operations in BIAC or made commitments to do.

Intimate Clothing, a subsidiary of MAS Holdings has set up two plants in India, one in Chennai and another in Bangalore, and an integrated fabric park in Chintavaram in Nellore District, Andhra Pradesh.. The two factories, which started operation in 2006, currently employ over 1500 and 1300 workers respectively. In 2007, MAS launched in India a range of lingerie under its own brand name, *Amante*'. This brand was developed and designed in Sri Lanka to suit the South Asian climate and local taste in colour and print. After the initial launch in Chennai and Bangalore, *Amante*' range of lingerie are now sold in departmental stores and regional multi-brad outlets all over India. The range of Amante brand sold in India was initially manufactured in Sri Lanka, but the production was shifted Chennai factory after three years. The company has plans to expand the distribution network to Pakistan and the Middle East from the Indian base. MAS has invested US\$ 10 million in the Amante line with the aim of making the product a premier brand in the Asian region.

The MAS fabric park, which located in a 714 acre site in Chintavaram, started operation in 2007 with an initial investment of \$200 million. It expects to generate US\$500 million export revenue and employ 30,000 workers in full capacity. The park is an integral part of MAS's global supply chain integration strategy, and is expected to attract investment in different stages of the manufacturing and finishing process of warp knit fabrics used in the production of corsetry, swimwear and sportswear. MAS has already set up two joint-venture companies in the park, one with Dogi Spain and Elastic Fabric of the USA and the other with Miami Exports (a Sri Lankan firm). A unique feature of the park is a training college, Asian Institute of management and Technology (AIMT), a knowledge centre for garment and textile technology, lean manufacturing and corporate social responsibility and community development programs.¹⁰

The other Sri Lankan firms in India are HDFI in nature, set up largely to take advantage of the market opportunities arising from the growth in the Indian consumer market. These include Ceylon Biscuits (Munchee brand), Lion Brewery (Carlsberg beer), John Keels, Hayleys, and Aitken Spence (Hotels). There are also a number of Sri Lankan firms involved in services industry, in particular freight servicing and logistics sector from. The Indian beer venture of Lion Brewery is an interesting case of a large MNE (Carlsberg International of the Netherlands) to venture into India. The progress of this joint venture in India has been impressive. The Company now operates four breweries, in Maharashtra, Rajasthan, Himachal and Kolkata.

Pakistan

Indian companies are not officially permitted to investment in Pakistan. However, there is some evidence of Indian investment occurring through unofficial channels. For instance, according to the *Locomonitor* (an electronics data base which tracks in media reports overseas investment by large companies) three Indian companies set up operations in Pakistan during 2002-2007: Tata Consultancy, UTI and Dabur India (an Ayurvedic product firms) (Aggarwal 2008). According to this source, Tata Consultancy and UTI (a leading financial services company) ranked among the top 5 investors in Pakistan during that period. In addition, there may have been considerable

¹⁰ http://www.fibre2fashion.com/news/printStory.aspx?new_id=43172

unrecorded investment undertaken by Indian nationals through long-established family-linked firms operating in Pakistan (Jayasuriya and Weerakoon 2002).

Pakistan Investment Board does not report individual country data on investment from the other South Asia countries, presumably because these are rather small and fewer in number. During 2000-2010, the share of the lump-sum category of the 'other countries' in total approved FDI (which presumably covers intra-regional investment) has varied in the range of 1% to 3%.

Bangladesh

There are 169 South Asian ventures among 1600 foreign-invested enterprises (FIEs) set up in Bangladesh during 1977-2011 (Table 3). India was by far the largest regional investor in the country accounting for 14% of total number of firms, 4.5% of total cumulative planned investment and 17.8% of total employment. Pakistan and Sri Lankan occupied the second and third positions, respectively, both in terms of the number of projects and cumulative investment. However, the Sri Lankan firms employed more workers (6778) compared to Pakistani firms (6535). This difference seems to reflect the greater concentration of Sri Lankan firms in export-oriented apparel industry, compared to Pakistani firms.

Table 3 about here

There are no firm-level data on export performance. But, the data on industry profile and the available limited information from project descriptions suggest that Indian and Pakistani manufacturing investment is heavily concentrated in domestic-market oriented activities (HFDI). By contrast, Sri Lankan investment is more efficiency-seeking (VFDI) in nature: of the 22 Sri Lankan firms 16 are in textile and clothing sector (which accounts for over 80% of Bangladeshi merchandise exports) and related activities (production of clothing accessories and clothing washing plants). The differences in the degree of export orientation of investment from the three countries also mirror in the differences in the degree of capital intensity of firms: the average capital per worker in Sri Lankan firms is US\$3390 compared to US\$8798 in Indian firms and US\$15476 in Pakistani firms (according to the data reported in Table 3).

The largest among the Sri Lankan firms operating in Bangladeshi clothing industry is Brandix Casualwear Bangladesh Ltd, which started operation in Comilla FTZ in October 2010. This production facility is part of Brandix Group's regional production chain; it produces woven bottoms for Marks and Spencer and GAP using fabrics from the Group's plant in India and clothing accessories from Sri Lankan production base. Brandix Casualwear Bangladesh is the first apparel producer in Bangladesh to receive 'Plan A' certification for environmentally friendly production from Marks and Spenser. When becomes fully operational, it will have a total works force of over 2,800.

It is important to note that activities of Sri Lankan firms tell only part of the story of Sri Lanka's involvement in the export-oriented apparel industry in Bangladesh. Many clothing factories in Bangladesh (both locally-owned and owned by investors from other countries) employ a large number of managers and technicians from Sri Lanka (Jacob 2013). Based on the early-mover advantage in export-oriented clothing industry (following the liberalisation reforms in the late 1970s) and the rich domestic human capital base Sri Lanka has become a hub of managerial and technical talents for the clothing industry in the region (and beyond)' (Jayasuriya and Weerakoon 2002, Wijayasiri and Dissanayake 2008).

Indian investment in Bangladesh could have been much higher if it were not for some Political constrains impacting on investment approval (Sobhan 2010). In the early 2000, India's leading conglomerate, Tata, came up with a proposal to invest about \$3.6billion in Bangladesh to set up a urea fertilizer plant, a steel mill and a power plant. The Mittal Group, the biggest steel conglomerate in the world, sought to invest \$2.5 billion in a steel mill. Both these projects had potential to create export trade with India, contributing to narrowing the persistent massive trade deficit in Bangladesh's trade with India. These projects also could have attracted significant FDI in gas explorations and development and have transformed Bangladesh's image as an FDI destination. But, unfortunately, materialisation of these projects remains captive to politics. The Bangladesh National Party (BNP) government, which held power in Bangladesh during 2001-06, stalled on taking decision on both projects. The public reason given was that Bangladesh could not guarantee enough gas supplies to the two projects to ensure their long-term sustainability. However, as forcefully argued by Sobhan (2010), presumably the real reason was that concerned that the approval of such large projects involving Indian investment just prior to a national

election would have been prejudicial to BNP's election stance against its main rival, the supposedly India-friendly Aswami League. The 'gas' argument seemed a non sequitur because these projects could have encouraged significant FDI in further gas exploration and development in the country.

Sri Lanka

Annual approved investment from India increased from US\$5 million in the second half of the 1980s to about US\$7.5 million by the late 1990s (Table 4). During the first decade of the new millennium, the average investment level was much higher compared to the previous decade, but fluctuated widely from year to year reflecting vicissitudes of the investment climate during the final stage of the ethnic conflict. Invest flows have been growing rapidly following the ending of the ethnic conflict in 2007. During 2010-11 India was the second largest investor in Sri Lanka (after Hong Kong)¹¹. Given the growing importance of India as a source of FDI, the Sri Lankan Board of Investment opened its first overseas branch in Bangalore on May 23, 2005.

Table 4 about here

Indian firms' involvement in Sri Lankan manufacturing dates back to the late 1960s when a number of joint ventures were set up in domestic-market oriented industries such as textile, glassware, refrigerators and machine tools. Most of these import-substitution firms went out of business following the liberalisation reforms initiated in 1977. In the 1980s and 1990s India had a relatively lower ranking among source countries of FDI in Sri Lankan manufacturing. The bulk of FDI in Sri Lankan manufacturing during this period was in export-oriented manufacturing (in particular clothing, footwear and other light manufactured goods) in which Indian firms do not have a competitive advantage in overseas production because of historical reasons (Lall 1986, Athukorala 2009). In recent years, Indian investors have gained prominence with a distinct service-sector bias. A number of factors, in particular the removal of restrictions on outward FDI by India, opening up of a number of services industries to FDI in Sri Lanka (in particular telecommunication and petroleum distribution), improvement in the overall investment climate following the ending of the civil conflict have underpinned these recent trends.

¹¹ The largest when Indian round-tripping investment taking place via Mauritius is taken into account (See Table 2, Note 2).

The industry profile of Indian investment in Sri Lanka is highly diversified, encompassing steel, cement, rubber products, tourism, computer software, IT-training and other professional services, and hotels and tourist resorts (Table 5). Until the late 1990s, most Indian FDI inflows to Sri Lanka were in manufacturing. Since then the composition has tilted rapidly in favour of services, such as hospitals, restaurants, retail trade and oil distribution. Some of the most visible Indian companies operating in Sri Lanka include Indian Oil Corporation, Tata (Taj Hotel, VSNL, Tata Tea, Tata Communication), Bharat Airtel, Apollo Hospital¹², Aditya Birla Group (L&T), Ambujas, Rediffusion, Ceat, Nicholan Piramal, Jet Airways, Ashok Leyland, and Hero Motors. Indian Human Resources and Educational Companies like ICFAI and Manipal Medical Institute have also set up operations in Sri Lanka.

Table 5 about here

Most of the manufacturing ventures set up by Indian investors in recent years are engaged in the production/assembly of certain product (such as vanaspathi¹³, copper wire¹⁴, machinery parts and components) which enjoys tariff preferences (zero or low duty) under the ISLFTA but are subject to high tariff on India's imports from third countries. By 2005, exports by these 'tariff- arbitrage' firms accounted for nearly 45% of total Sri Lankan exports (US\$559) to India, with vanaspathi and copper wire accounting for 22% and 28% of the total, respectively. In recent years, these exports have shown a sharp decline as the arbitrage margins eroded over time owing to multilateral tariff cuts in India (de Mel and Jayaratne 2012).

There are only a few Indian firms which have set up operations in Sri Lanka to exploit Sri Lanka's intrinsic comparative advantage in international production. Among them, perhaps the most prominent is the Indian tyre manufacturer, Ceat (a subsidiary of RPG Enterprises, one of India's largest conglomerates). It first set up a joint venture in 1993 with a Sri Lankan company (Associated Motorways) which had a long-standing reputation in automobile and tyre trade. In

¹² This was taken over by the Sri Lankan partner (the government-owned Sri Lanka Insurance Corporation) in 2008.

¹³ A type of vegetable oil derived from palm oil.

¹⁴ Extracted from imported scrap metal.

1999 it acquired the largest local tyre manufacturing company (Kelani tyre, previously government owned) and amalgamated the two firms to form Ceat Holding Company (CHC) Pvt. CHC is now the largest tyre manufacturer in Sri Lanka. By 2010 it had captured 55 per cent of the domestic passenger vehicle market, 33% of the three-wheeler tyre market, and 45% of light truck tyre market. Following successful domestic market operation, CHC has started exporting tyres to 14 countries in the world: Bangladesh, Pakistan, Mauritius and Nepal and a number of countries in Africa and the Middle East. It is so far the only tyre manufacturing firm in Sri Lanka to obtain ISO 9000 certification (CII 2012).

Ceat's join-venture operation in Sri Lanka is clearly illustrative of opportunities for creating intra-regional trade and investment linkages through market oriented reforms. The initial trade liberalisation in Sri Lanka permitted early penetration of the vehicle market by Indian firms. This also created opportunities for Indian tyre manufacturers to supply the Sri Lankan market, using their specific technological assets and Indian production bases. The privatisation program in Sri Lanka provided an investment opportunity to capitalise on cheap Sri Lankan rubber-reflecting the country's comparative advantage. Liberalisation in India facilitated outward FDI. The firm-specific assets accumulated over many years through successful operation in India enabled Ceat to produce tyres for both the Sri Lankan and export markets (Jayasuriya and Weerakoon 2002).

In the export-oriented clothing industry in Sri Lanka, Indian firms are small players compared to both Sri Lankan firms and firms from other countries. They have set up production bases in Sri Lanka mainly to access the Sri Lankan managerial and technical/design capabilities in producing for third-country markets¹⁵. Some of them are sub-contractors to large Sri Lankan exporting firms.

According to the official records of the Sri Lanka board of Investment, by the early 2000 were eight Pakistanis firms (textile (4), apparel (2), gloves (1), paper/packaging (1)) and a Bangladesh firm (photocopy paper) operating in Sri Lanka. There has not been any recorded investment from these two countries since then.

¹⁵ There is no relative labour cost advantage; the average factor-worker wage is now much higher in Sri Lanka (US\$ 150 to 180) compared to that in India (around US\$100 to 120).

Nepal

According to the data on cumulative foreign investment in Nepal as at 2011, intra-South Asian invests account for 26% of total number of foreign-invested firm, and 41% of employment and 48% total cumulative investment in these firms (Table 6). India is by far the largest source country, followed by Bangladesh, Pakistan and Sri Lanka, and Bhutan in that order. There is no recorded investment from Maldives

Table 6 about here.

Manufacturing accounts for more than half of the recorded projects and 60% of the total planned investment. Out of the total reported Indian projects (501) 60% are in manufacturing and they account for nearly 65% of total cumulate investment. Among the other sectors, hotel and tourism show the large concentration of FDI given the attractiveness of Nepal as a tourist destination.

Until 2005 when the export-quotas under the Multifibre Arrangement (MFA) were in force, a large number of Indian firms set up production plants in the clothing Industry in Nepal to circumvent MFA quota applicable to garment exports from India. There is no annual data to assess the implications of MFA abolition for foreign investment in the clothing industry (Athukorala and Sharma 2006). But, judging from the data on clothing exports from Nepal during the post-MFA years, it seems that most (if not all) of these ‘quota-hopping’ firms would have gone out of business after the ‘easy access’ to quota protected markets disappeared.

A major inducement for the bulk, if not all, of the other Indian investors has been the opportunity to make profit through ‘import deflection’. Because of successive tariff cuts from the late 1980s, tariffs on many intermediate products imports in Nepal are now much lower than in India. These tariff differentials, combined with virtual open border between the two countries, have attracted a number of Indian firms to set up plants in Nepal (in industries such as, copper wire and some cosmetics) to import some products such as vegetable ghee, scrap metal and some cosmetics in bulk/raw form and re-export to India after doing some simple processing.

Nepal has untapped potential for hydroelectricity production for both the domestic market and for neighbouring states in India through FDI participation. Currently over 80% of electricity demand in the country is met by electricity purchased from India. The estimated hydro-electric power potential of Nepal is about 45,610 MW, but a mere 1.37% of this is currently exploited (Lama 2010. Table 6.2). India and Nepal started cooperating in the construction of a number of projects including Gandak (15MW), Kosi (18MW), Trisuli (21 MW), and Devighal (14MW) during the 1960s and 1970s. However, little has been done since then; the Karnadi, Rapti, and Pancheswar projects have been under negotiation for nearly four decades without any progress because the two countries' failure to agreeing on how to share the benefits of these projects. The situation has become more complex because of domestic power politics over the past decade (Lama 2010). The government monopoly in electricity distribution and the compulsion for private-sector electricity producers to supply to the national supply grid (owned and managed by the Nepalese Electricity Authority) have also been a major hurdle for FDI in this sector.

Bhutan and Maldives

There are no data on FDI inflows to Bhutan and Maldives disaggregated by the country of origin. In Bhutan India is believed to be the largest investor, with investment predominantly in hydropower (Dorji 2011). Unlike in Nepal, Indian involvement in harnessing water resources has been widely accepted in Bhutan; all hydropower projects in the country are jointly owned and managed by Indian companies in collaboration with the government owned companies. There has also been some investment by Singapore and India in tourism and the financial sector.

Sri Lankan and Indian firms have a significant presence in tourist resorts and hotels, and tourism-related services in Maldives (WTO 2003). In the late 1990s some Sri Lanka clothing firms set up production bases in Maldives in order to circumvent quota restriction imposed under the Multi-Fibre Arrangement on their exports to developed-country market from the home base. These production bases were shifted back to Sri Lanka after the MFA phasing out in 2005 (Adhikari and Weeratunge 2007).

Intra-regional FDI: Comparative Analysis

In order to provide the context for analysing the magnitude and patterns of intra-regional FDI, total FDI inflows to, and outflows from, the countries in the region are summarised in Tables 7 and 8. FDI inflows to South Asia were rather small in the 1960s and 1970s. Following the liberalisation reforms, there has been some increase, but the combined regional inflows amounted to a mere 3% of total (global) flows and 5.1% of flows to developing countries. India accounts for the lion's share (over 90%) of total inflows to the region.

Table 7 about here

Table 8 about here

On the outflow side, total outward FDI from India recorded a notable increase from the early 2000 and surged from 2005 following the substantial removal of foreign exchange restrictions on capital transfer for overseas acquisitions. Total FDI outflow from India increased from about US\$ 20 million in the early 1990s to nearly US\$ 15 billion in 2011, albeit with some annual fluctuation. Over the past decade India has been the third largest foreign direct investor in the developing world after China and Brazil.¹⁶ However, India still remains a net FDI recipient, even though the gap between outflow and inflows has been sharply narrowing over the past few years. During the 1990, annual out flows on average amounted to 7% of inflows. This increased from about 30% to 60% between 2000-5 and 2010-11. Outward FDI from the other countries in the region still remains small and only the figures for Sri Lanka has indicated a continuous increase over the past five years, albeit from a very low base.

How important are the intra-regional FDI inflows to the South Asia countries compared to total inflows to these countries? The available data does not permit a precise comparison. The data pieced together in the previous section from FDI monitoring agencies in individual countries suggest that they account for rather small share, perhaps less than 5% of the total cumulative FDI in the region by the turn of the last decade. At the individual country level, regional inflow seems to account for a significant share only in Nepal and the tiny countries of Maldives and Bhutan. In Sri Lanka, India has been the largest source country in recent years, but it still account for around 13% total inflows.

¹⁶ This based on based FDI outflow data from UNCRAD, *World Investment Report database*.

India is by far the largest global investor in South Asia. However, the regional share of Indian outward investment has declined continuously, from 4.5% in 2003-04 to a mere 0.1 in 2006-07 (Table 9). Among the South Asian countries, Sri Lanka is the largest recipient of Indian FDI. In 2006-07, Sri Lanka received 85.0% total intra-regional Indian FDI followed by Bangladesh (11.1%). The data also points to a notable decline in the share of Nepal in India's intra-regional FDI. In addition to the political instability in the country, phasing out of MFA in 2005 which put an end to quota-hopping investment, and gradual dissipation of profitability of 'tariff arbitrage' due to significant tariff cuts in India in recent years seem to have contributed to this decline.

Table 9 about here

A general characteristic of FDI from developing countries (or, FDI by the so called emerging market multinational enterprises) is its heavy concentration in developing countries. Moreover, the bulk of their FDI is intra-regional, mostly in neighbouring countries. Until recently Indian companies investing overseas shared this general pattern of developing-country concentration, although they were unique for their wider spread within the developing world. The past decade has, however, seen a clear compositional shift in Indian FDI in favour of developed countries and transitional economies (Athukorala, 2009, Table 2).

The significant shift in Indian FDI away from developing countries, and in particular the sharp decline in the share of intra-regional investment has been underpinned by a notable shift in the sectoral/industry composition of overseas activities of Indian firms. Manufacturing share in total approved Indian FDI declined from 70% in the early 1990s to 30% by the middle of this decade, reflecting a notable services sector bias. Within manufacturing, iron and steel, pharmaceuticals, automotive, chemicals and fertiliser have become the major areas of concentration. Overseas operations of Indian MNEs in these product areas are predominantly horizontal (market-seeking) in nature, with a strong preference for locating in countries with large domestic markets. Tariff jumping motive, which was an important driver of their location in developing countries, in the past has lost its relevance because of the significant across-the-board tariff cuts in these countries over the past few decades. Notwithstanding significant trade and investment liberalisation coupled with dismantling of the industrial licencing, so far there are no significant globally-oriented firms in electronics and electrical industries (other than in

computer software) in India. Computer software is a notable exception, but most of the Indian global players in this industry are generally at the lower rungs of the vertically integrated global production chain with limited potential for further slicing of the value chain to generate VFDI within the region (Bhide' 2008).

As regards the industry/sectoral composition of regional FDI, HFDI has continued to account for the bulk of intra-regional flows, with a notable shift from domestic-oriented manufacturing to services and construction. However, there are early signs that VFDI has begun to play a role in stimulating intra-regional trade. The most prominent case is the textile and garment sector in which Sri Lanka is emerging as the hub of technology and managerial talents. Emerging patterns of textile and garment exports from the region show that there are Substantial differences among countries in in terms of their competitive advantage different segments/product lines in global markets — Pakistan: bed linen, home furnishing, carpets, basic menswear (in particular denim) and hosiery; Sri Lanka: lingerie, swimwear and formalwear; Bangladesh: men's wear, sports and casualwear; and India: women tops, blouses, skirts, embellished and embroidered clothing and men's underwear (Tewari 2007). Moreover, India and Pakistan have established textile (fabric) industries with unexploited potential for supplying fabrics to garment producing firms. Given these complementariness, there is significant potential for trade and investment expansion in the region through vertical specialisation in the clothing and textile sector. There is also some evidence, in particular from Sri Lanka, of regional investment of HFDI variety in some other industries driven by the availability of specific natural resources or skilled manpower.

5. Concluding remarks

Total annual flows of FDI into the South Asian region has increased substantially following the market-oriented policy reforms initiated three decades ago, but they still account for a small share (around 3%) of total global flows. India continues to account for over 90% of these flows. Compared to total inflows, intra-regional inflows of FDI seem to have increased at a slower rate and still they accounted for about 5% total cumulated FDI in the region over the past three decades.

Total outward investment by Indian MNEs has increased rapidly in recent years; Indian is now the third largest investor in the developing world after China and Brazil. But, the intra-regional share of total outward FDI from India has shrunk in recent years. Indian overseas FDI, both global and regional, is predominantly of horizontal type (market seeking). Notwithstanding significant trade and investment liberalisation coupled with dismantling of the industrial licencing, so far no significant globally-oriented firm with potential for slicing the value chain among countries has emerged in Indian manufacturing.

Horizontal FDI has continued to dominate the composition of South Asian intra-regional FDI, with a significant shift in recent years in favour of services sector activities. There are some indications of vertically integrated cross-border production operations emerging, but it is unlikely that these emerging patterns would be powerful enough to transform regional trade patterns so as to substantially reduce the region's dependence on extra-regional markets for trade expansion in the foreseeable future. These nascent vertical production chains have so far remained confined to a few product lines, predominately garment and also to some industries in which the availability of specific natural resources plays an important role in firms' location decisions. In other industries, including electronics and electrical goods in which global production sharing is heavily concentrated, so far no significant new regional firms with the capacity to undertake significant outward FDI have emerged. The Indian computer software industry is the often-cited example of South Asian success in joining global production networks. But most of the Indian global players in this industry are at the lower rungs of the vertically integrated global production chain with limited potential for further slicing of the value chain to generate VFDI within the region.

There are no data to probe the impact on the trade-FDI nexus of the preferential tariff cuts achieved so far under SAFTA and the bilateral FTAs that have been in force. However, information put together in this paper suggests that it was the cross the border liberalisation of trade and investment regimes (both unilaterally and as part of the WTO commitments), which has set the stage for the emergence of VFDI in the region. The Sri Lanka export-oriented clothing industry, which has begun to act as the hum of the textile-clothing value chain in the region, grew out of the significant concurrent liberalisation of trade and investment policy reforms in the country over the past three decades. Liberalisation reforms in India and

Bangladesh enabled leading clothing firms in Sri Lanka to set up production bases in India and Bangladesh. It is important to note that the entry of these firms to set up integrated production complexes in India predates the signing of the India-Sri Lanka FTA. India-Sri Lanka FTA was instrumental in attracting some ‘tariff- arbitrage’ manufacturing firms to Sri Lanka firms, but, naturally, they have not had a lasting impact of Sri Lanka-India bilateral trade. When the Sri Lanka-Pakistan FTA was signed in 2002, there was much hope that it would enable Pakistani firms to set up production based in Sri Lanka to trade with India by circumventing the preparing prohibition on using land routes to export goods to that country. But so far no single Pakistani firm has set up production bases in Sri Lanka.

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Table 1: A Summary of Trade Regimes in South Asian Countries, circa 2011

Policies	Bangladesh	Bhutan	India	Maldives	Nepal	Pakistan	Sri Lanka
Exchange Rate	Unified	Unified	Unified	Unified	Unified	Unified	Unified
Exchange Rate Determination	Free Float	Peg to Indian Rupee	Free Float	Fixed Parity against US\$	Peg to Indian Rupee	Managed Float	Managed Float
Payment Convertibility							
Current Account (IMF Article VII status)	Yes, Some Limit	Yes	Yes	Yes	Yes	Yes	Yes
Capital Account	No	No	Yes, limited	Yes	No	No	No
Import Restrictions							
Import Licensing	No		No	Yes	Yes, Limited	No	Yes, Limited
QRs on Imports	Yes, Limited		No	Yes	Yes	No, Minor Rest:	Yes, Minor
State Monopolies	Yes		Yes	Yes	Yes	Yes	Yes
MFN Tariff Simple Average	14.6	21.9	14.1	20.2	12.6	13.5	11.4
Applied Tariff Trade Weighted	13.2	14.8	7.8	20.5	14.6	14.7	9.5
Tariff binding coverage at WTO	15.5	No	73.8	97.1	99.4	98.7	37.8
Average of Bound Tariff Rates	169.2	N/A	50.2	36.9	26.0	59.9	30.3
Ease of Doing Business (rank out of 181)	110	124	122	69	121	77	102
Logistic Performance Index (1-to 5 best)	2.5	2.2	3.1	N/A	2.1	2.6	2.4

Source: Athukorala, Bandara and Kelegama 2011 (updated to 2011 using the same sources)

Table 2: Foreign Investment Policy Regimes in South Asian Countries

Areas	Bangladesh	India	Nepal	Pakistan	Sri Lanka	Bhutan	Maldives
Limits on foreign Equity Participation	100%	Up to 51% in most industries; Up to 24% in small scale industries; and 100% in export-oriented industries, power, electronic and software technology parks. Investment from Pakistan remained prohibited until 1 September 2012	100% foreign owned or joint venture in all sectors, except for a negative list industries	100% in all sectors.	100% in all sectors	70% in all sectors	100%
Fiscal Incentives	i) Tax holiday for 7 years ii) Tax exemption on royalties, interest on foreign loans and capital gains from the transfers of shares iii) 5% import duty on capital equipment and spare parts for initial installation	i) Income tax holiday of 10 year for EPZ firms and 5 year for other investors. ii) Access to finance for export-oriented industries at concessional interest rates iii) Tax relief under Avoidance of double taxation agreements iv) 10 year income tax holiday for firms located in EPZ.	(i) Corporate tax rate for export-oriented industries is 8% of profit or 0.5% of export earnings ii) Corporate tax rate for import competing industries is 20% iii) 2.5% duties on imports of M/E and spare parts iv) 5-10% duties on most industrial intermediate inputs refunded to export-oriented industries under the duty draw back scheme	i) No custom duty on imports of plant, machinery & equipment for export-oriented and hi-tech industries ii) zero import tariff on plant and machinery (not available locally) used for agriculture	i) Exempted from income tax on capital gains arising from share transfers ii) income tax??? iii) Duty draw back for export-oriented industries	Selective tax exemption	No specific tax incentives
Repatriation of Profits and tax on expatriates income	100% repatriation of capital and dividends is allowed	100% repatriation of capital, profits and dividend is allowed after payment of tax	100% repatriation of dividends and capital is allowed	100% repatriation of capital, dividend and profits is allowed	i) 100% repatriation of profits and dividend is allowed ii) expatriates income is taxed at a concessional rate of 15% for 5 years	100% repatriation of profits and dividend subject to approval	100% repatriation of profits and dividend is allowed
Minimum capital requirement	None	US\$2100	None	Agriculture and infrastructure: \$0.3mn Telecom: \$0.15 Mn.	US\$500,000	Manufacturing: US\$1Mn Services: US\$0.5 Mn	None
EPZ status	Yes, in some designated area	Yes, in some designation area	No	Yes, in some designated area	Yes, country-wide		

Protection of Foreign Investment	i) Guarantee against nationalization ii) International convention for settlement of industrial disputes	i) Settlement of disputes is govern by the Indian Arbitration Act 1940 ii) UN Convention for the recognition and enforcement of foreign arbitral awards	i) Guarantee against national ii) Dispute settlement through mutual consultations and in accordance with the arbitration rules of UN Commission on International Trade Law	i) Guarantee against nationalization ii) Settlement of dispute through the International Commission on Settlement of Investment Disputes	i) Protection against nationalization under the bilateral investment agreements and constitutional guarantee ii) International Convention for the Settlement of Investment Disputes		
Outward direct investment	All foreign investment require prior approval	Overall limit of \$100 million in one financial year subject to approval. Investment by Indian nationals in Pakistan was not permitted under the approval route.	Nor permission is given for foreign investment for Nepalese citizens except by Only by government notice	All foreign investment require prior approval	All foreign investments require prior approval. Priority to investments which promote domestic exports	Strict controls on all foreign investments	Strict controls on all foreign investments

Source: IMF, *Annual Report on Exchange Arrangements and Exchange Restrictions* supplements by various country sources.

Table 3: South Asian Investment in Bangladesh at 2011

Source country/Industry	Number of Firms	Cumulative investment (US\$ million)	Employment
INDIA			
Manufacturing	108	266.083	30243
Food	18	20.1	2127
Textile	2	20.4	2177
Clothing	24	54.2	17699
Leather products/footwear	3	36.1	2754
Wood products	1	0.5	51
Paper & paper products	3	2.4	255
Chemical, rubber and plastic	32	62.1	3626
Fabricated metal products	17	66.6	886
Other manufacturing	8	3.7	668
Construction/housing	4	4.2	468
Comp. software and IT services	19	8.8	1277
Trade and services	11	29.6	1479
Clothing washing plants	6	7.5	1099
Total	142	308.635	33467
PAKISTAN			
Manufacturing	39	93.4	6035
Food	2	11.5	120
Textile	6	12.3	672
Clothing	6	6.8	2943
Leather products/footwear	1	0.1	30
Wood products	1	0.1	15
Paper & paper products	2	4.1	322
Chemicals, rubber and plastic	6	1.4	404
Non-metallic mineral products	1	0.4	27
Fabricated metal products	10	56.0	1245
Other manufacturing	4	0.8	257
Construction/housing	2	1.4	333
Comp. Software & IT services	1	0.5	62
Trade and services	4	2.5	105
Total	46	97.7	6535
SRI LANKA			
Manufacturing	23	29.0	6778
Food and beverages	2	0.3	151
Textiles	2	7.4	151

Clothing	7	10.1	5463
Chemicals, rubber and plastic	2	0.4	148
Fabricated metal products	2	0.5	51
Miscellaneous manufacturing	8	5.2	814
Clothing accessories	4	2.8	219
Computer software and IT services	4	1.4	151
Trade and services	6	27.0	1121
Clothing washing plants	1	0.5	102
Total	31	51.4	8050
<i>Memo items</i>			
FDI from all source countries	1598	10179.5	26007
South Asian share	13.7	4.5	17.5
India	8.9	3.0	12.7
Pakistan	2.9	1.0	2.4
Sri Lanka	1.9	0.5	2.7

Source: Compiled from data extracted from Bangladesh Board Investment website.

Table 4: Indian Direct Investment in Sri Lanka, 1984-2011

	Total FDI (US\$ Mn)	FDI from India		India's rank among source countries
		US\$ Mn	Share (%)	
1984-89	50.0	5.1	12.2	12
1990-94	231.0	7.5	3.2	14
1995-99	433.6	7.6	1.7	8
2000	173.5	1.9	1.1	8
2001	121.3	14.4	11.9	5
2002	168.0	101.3	60.3	1
2003	158.4	53.8	34.0	1
2004	214.0	25.2	11.8	4
2005	249.0	17.9	7.2	4
2006	506.2	27.1	5.4	9
2007	644.7	42.9	6.7	4
2008	779.0	126.0	16.2	2
2009	601.0	78.0	13.0	3
2010	516.3	110.2	21.3	1
2011	1067.0	147.0	13.8	2

Notes

- (1) The sharp increase in India's share was mainly due to IOC investment of US\$44.7 investment in that year.
- (2) For the first time BOI records indicate FDI inflows from Mauritius during 2009-2011: 2009: US\$12 Mn, 2010: US\$ 15 and S2011: US\$253. Presumably the bulk (if not all) of these are Indian investment 'round-tripped' via Mauritius in order to reap tax advantages under the India-Mauritius Bilateral Investment Treaty.

Source: Data for 2003-2011 are from CII (2012) (data provided by the Sri Lanka Board of Investment). Data for 1984-2002 were compiled from BOI records and Central Bank of Sri Lanka, Monthly bulletin of Statistics (various issues)

Table 5: Industry Profile of India Direct Investment in Sri Lanka, as at 2010

	Number of firms	Cumulative approved Investment (US\$ Mn) ¹			Exports in 2009 (US\$ Mn) ¹	Planned Employment (number)
		LOCAL	FOREIGN	Total		
Manufacturing	81	15.1	99.2	114.3	135.4	9,772
Food, beverages and tobacco	14	3.9	30.5	34.4	4.9	1,688
Clothing	13	2.8	9.6	12.4	37.0	4366
Textile	2	0.0	1.0	1.1	1.7	491
Wood and wood product	3	0.0	1.1	1.1	3.5	219
Printing and publishing	2	0.0	1.2	1.2	3.2	94
Chemical, petroleum and rubber products	9	2.5	3.7	6.2	10.4	781
Automobile tyres (CEAT India)	1	1.0	1.5	2.5	---	281
Non-metallic mineral products	8	0.8	6.1	6.8	4.0	286
Fabricated metal products	21	3.5	32.3	35.8	27.5	634
Other manufacturing	9	1.6	13.6	15.2	43.1	1,213
Construction of commercial building and housing complexes	5	4.2	10.0	14.2	0.0	29
Service and trade	18	34.9	234.1	269.0	29.2	1,043
Data processing/software	5	0.8	4.0	4.8	3.4	480
Mobile telecommunication (Bharat Airtel)	1	0.0	186.1	186.1	0	195
Petroleum retailing (Indian Oil Corporation)	1	31.3	37.4	68.6	0	176
Total	104	54.2	343.6	397.8	164.6	10,852
Memo items						
Total foreign invested projects in Sri Lanka	852	984.2	3,535.8	4,520.0	2,986.7	221,956
Share of Indian FIEs (%)	12.2	5.5	9.7	8.8	5.5	4.9

Note: Values in Sri Lankan rupee converted at US\$/SLR = 114.4.

--- Data not available.

Source: Compiled from unpublished records of the Board of Investment, Colombo.

Table 6: South Asian Direct Investment in Nepal as at 2011

Sour country/sectors	No of Projects	Total investment	Investment	Employment
BANGLADESH	26	7.0	3.6	4166
Agriculture	1	0.1	0.1	100
Construction	1	0.1	0.1	20
Manufacturing	9	5.8	2.7	3310
Service	9	0.6	0.4	202
Tourism	6	0.3	0.2	534
Bhutan	3	0.4	0.0	98
Manufacturing	1	0.1	0.0	0
Service	1	0.1	0.0	12
Tourism	1	0.2	0.0	86
INDIA	501	847.4	437.6	56407
Agriculture	7	10.7	5.6	784
Construction	17	30.3	25.3	830
Energy Based	12	112.6	69.5	1222
Manufacturing	296	398.4	198.4	36142
Mineral	6	60.5	30.5	1521
Service	112	166.9	87.6	11781
Tourism	51	67.9	20.5	4127
PAKISTAN	15	29.3	2.0	2403
Manufacturing	7	3.8	1.6	2288
Service	5	25.2	0.3	57
Tourism	3	0.3	0.1	58
Total		0.0	0.0	
SRI LANKA	4	1.2	0.6	99
Service	4	1.2	0.6	99
Total	549	885.3	443.9	63173
Memo items				
Direct investment from all countries	2108	2056.0	919.3	155432
South Asian share (%)	26.0	43.1	48.3	40.6
Bangladesh	1.2	0.3	0.4	2.7
Bhutan	0.5	0.0	0.0	0.2
India	23.8	41.2	47.6	36.3
Pakistan	0.7	1.4	0.2	1.5
Sri Lanka	0.2	0.1	0.1	0.1

Source: Compiled from, Government of Nepal, *Industrial Statistics 2011*, Kathmandu: Department of Industry.

Table 7: Foreign Direct Investment Inflows, (1990-2011) (US\$ million)

	1990-94	1995-99	2000-04	2005	2006	2007	2008	2009	2010	2011
South Asia	968.3	3 731.9	6 305.6	11 295.8	26 272.0	32 689.4	50 959.6	39 322.7	28 098.1	34 791.8
Afghanistan	0.0	1.0	59.1	271.0	238.0	188.7	94.4	75.7	211.3	83.4
Bangladesh	6.7	356.8	415.9	845.3	792.5	666.4	1 086.3	700.2	913.3	1 136.4
Bhutan	0.4	0.4	1.6	9.1	72.2	3.0	7.2	18.3	16.3	13.9
India	413.9	2 619.2	4 958.8 ¹	7 621.8	20 327.8	25 505.6	43 406.3	35 595.9	24 159.2	31 554.0
Maldives	6.9	10.4	30.4	73.2	95.2	126.5	174.2	152.1	211.8	281.6
Nepal	1.6	11.7	5.8	2.5	- 6.6	5.9	1.0	38.6	86.7	95.5
Pakistan	419.9	536.1	633.4	2 201.0	4 273.0	5 590.0	5 438.0	2 338.0	2 022.0	1 327.0
Sri Lanka	118.8	196.4	200.6	272.0	480.0	603.4	752.2	404.0	477.6	300.0
Meme Items: FDI outflow as a % of,										
Global outflow	0.5	0.6	0.8	1.2	1.8	1.7	2.8	3.3	2.1	2.3
Outflow from developing countries	1.6	2.1	2.8	3.5	6.2	5.7	7.8	7.6	4.6	5.1

Increase in recorded FDI inflows during this sub-period partly reflects revisions to the estimation procedures. The Reserve bank of India revised the FDI estimation procedure in 2003 9with effect from 2001) to include retain earnings. In 2001 and 2002, this new component accounted for about 40% of the total reported FDI figures (RBA, Monthly Bulletin, January 2004, Table 46).

Table 8: FDI outflow from South Asia, 1990-2011 (US\$ Mn)

	1990-94	1995-99	2004-05	2005	2006	2007	2008	2009	2010	2011
South Asia ²	22.0	145.6	1 574.3	3 071.8	14 426.6	19 768.4	19 376.5	16 047.4	13 259.1	14 873.2
Bangladesh	0.3	4.1	7.7	3.3	3.6	21.0	9.3	29.3	15.4	9.2
India	20.3	119.8	1 528.2	2 985.5	14 285.0	19 594.4	19 256.5	15 927.1	13 151.0	14 752.0
Pakistan	- 3.0	10.8	29.0	45.0	109.0	98.0	49.0	71.0	47.0	62.0
Sri Lanka	4.4	10.9	9.4	38.0	29.0	55.0	61.7	20.0	45.7	50.0
Memo Items:										
FDI outflow as a % of,										
Global outflow	0.0	0.0	0.2	0.3	1.0	0.9	1.0	1.4	0.9	0.9
Outflow from developing countries	0.1	0.2	2.3	2.3	6.0	6.2	5.9	6.0	3.3	3.9

Note:

- (1) Annual average.
- (2) No recorded outflow data for Nepal, Maldives and Bhutan (presumably negligible)

Source: Compiled from UNCTAD, FDI/TNC database (www.unctad.org/fdistatistics).

Table 9: India's Intra-regional Outward FDI, 1996-2007

	Total	South Asia		Host country composition (%)				
	US\$ Mn	US\$ Mn	%	Bhutan	Bangladesh	Maldives	Nepal	Sri Lanka
1996-02	6354	165	2.6	0	9.1	12.8	40.7	37.4
2002-03	1334	16	1.2	0	7.4	0	35.6	57.0
2003-04	1191	54	4.5	0	7.6	0	9.9	82.6
2004-05	2263	16	0.7	0	11.1	0	24.9	64.1
2005-06	2136	21	1.0	0	5.9	5.4	3.9	84.9
2006-07	5371	5	0.1	0.9	11.1	0.9	2.1	85.0
Total	18654	280	1.5	1.8	8.4	7.9	29.5	51.4

Source: Aggarwal (2008) (Based FDI approval records of the Ministry of Finance, India)

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