

Chapter 8

Regional Investment Co-operation in South Asia

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8.1 Background

Although theoretically foreign direct investment (FDI) and trade are considered to be substitutes for each other, evidence suggests that FDI could exploit those markets better by using its intangible assets that cannot be substituted by trade (Bloström and Kokko 1997; Caves 1996). These intangible assets of foreign companies include technological and marketing expertise, which could be used for exploiting knowledge of local markets, consumer preferences and business practices, etc. Under an integrated regional market, FDI from member countries could target each other's market with a view to operating with low-tariff barriers. Such kinds of operation would be effective when production networks within the region function in a vertically integrated manner. In those markets, extra-regional FDI would take advantage of tariff barriers and large regional markets, etc. Despite the advantages of an integrated market, all locations within the region may not attract intra- and extra-regional investments at the same level; countries which have strong locational advantage could attract most of the FDI (Bloström and Kokko 1997). In other words, investment between member countries in an integrated region may be differentiated by differences in size of economy, variation in economic policies, poor physical and non-physical infrastructure facilities, lack of cross-border facilities and political factors (Sobhan 2004). Overall, an integrated regional market could facilitate 'investment creation' at a large scale both by intra-regional and extra-regional FDI. Promotion of FDI in South Asia should take that perspective into account in its initiative for regional co-operation for investment.²

Despite liberalising investment policies, undertaking various support measures under national policies and signing investment treaties with major investment sources by countries in South Asia, FDI in the region has remained at a low level. During 2011, FDI flow in South Asia was US\$35 billion, which was a mere 1.6 per cent of the global flow of FDI; similarly, the stock of FDI in South Asia was only 2.3 per cent of total global FDI stock at the end of 2011. Except India, none of the South Asian countries has received a considerable amount of FDI, which indicates a lack of diversity in terms of location of FDI within the region. Needless to say, intra-regional FDI flow has accounted for a small share of total FDI flow. This poor state of FDI flow in South Asia raises doubt about the efficacy of various policy measures undertaken by South Asian countries since the late 1980s despite the fact that national, bilateral and regional policies undertaken by developing countries, in general, have had a positive impact on the FDI flow (Banga 2003).

Promotion of regional FDI through application of specific policy instruments did not get due attention in the South Asian Association for Regional Cooperation (SAARC) framework. SAARC declarations in the late 1980s, 1990s and early 2000s put little focus on this issue; it has only been addressed in recent SAARC summits. Moreover, SAARC initiatives for the promotion of FDI appear to be undertaken within the framework of regional trade integration. Given the limited level of intra-regional trade in South Asia and weak interlinkage between trade and investment, there is doubt about the efficacy of existing trade-based initiatives to promote investment in South Asia. Intra-regional investment in South Asia also faces a number of other constraints, which include structural barriers, institutional bottlenecks, political tensions, narrow nationalism and mutual distrust (Aggarwal 2008; Jayasuriya and Weerakoon 2002). The existing initiatives address those challenges very little and therefore are not able to cater for more FDI in the region.

The present chapter focuses on two issues: (a) understanding the current state of national and regional policies and institutional arrangements for enhancing regional co-operation for investment and (b) putting forward suggestions for the development of an effective policy framework for enhancing intra-regional investment in South Asia. The chapter comprises seven sections. Sections 8.2 and 8.3 provide a brief overview on the structure and composition of FDI in South Asia and the FDI-related policies practised in South Asian countries. Section 8.4 analyses the existing institutional approach for enhancing intra-regional FDI, particularly under the SAARC framework. Section 8.5 discusses the institutional framework in the Association of Southeast Asian Nations (ASEAN) for enhancing FDI in South East Asia with a view to appreciating the possible lessons for strengthening institutional initiatives under the SAARC framework. Section 8.6 provides a set of recommendations for strengthening institutional measures to enhance intra-regional investment in South Asia. Finally, Section 8.7 summarises the major findings of the chapter.

8.2 Foreign direct investment in South Asia: A brief overview

South Asia is the lowest recipient region of FDI in the world; of the US\$1.5 trillion global flow of FDI in 2011, only US\$35 billion was directed to this region (Table 8.1). In contrast, FDI flow to other regions was quite high; for example, US\$452 billion in the European Union (EU), US\$267.8 billion in North America, US\$116.6 billion in South East Asia, US\$42.7 billion in Africa and US\$217 billion in Latin America. Other than India, none of the locations in South Asia is considered to be locationally advantageous for investment by foreign companies, including transnational corporations (TNCs), and, more importantly, these corporations perceive India to be the investment destination with the third most potential (Bartels et al. 2009; UNCTAD 2012). Except India, most of the locations in South Asia suffer from various constraints and weaknesses. India's liberal economic policy, large domestic market, skilled workforce, infrastructural facilities, natural resources, and technological and productive capacity have made it an attractive investment destination. As a result, FDI is increasingly concentrated in India – from 35 per cent of total regional stock of FDI in 1990 to 85 per cent in 2011. Consequently, the share of other South Asian countries (Pakistan, Bangladesh and Sri Lanka) has decreased over time. Both

Table 8.1 FDI in South Asia

Region/Economy	2006	2007	2008	2009	2010	2011
South Asia (US\$ million)	26,271	32,689	50,958	39,323	28,098	34,791
<i>Share of FDI flow in South Asia (%)</i>						
Afghanistan	0.9	0.6	0.2	0.2	0.8	0.2
Bangladesh	3.0	2.0	2.1	1.8	3.2	3.3
Bhutan	0.3	0.0	0.0	0.0	0.1	0.0
India	77.4	78.0	85.2	90.5	86.0	90.7
Maldives	0.4	0.4	0.3	0.4	0.8	0.8
Nepal	0.0	0.0	0.0	0.1	0.3	0.3
Pakistan	16.3	17.1	10.7	5.9	7.2	3.8
Sri Lanka	1.8	1.8	1.5	1.0	1.7	0.9
<i>Share of global flow of FDI (%)</i>						
South Asia	2.0	2.0	3.0	4.0	2.0	3.0
South East Asia	4.0	4.0	3.0	4.0	7.0	8.0
East Asia	9.0	8.0	10.0	13.0	15.0	14.0
Africa	3.0	3.0	3.0	4.0	3.0	3.0

Source: Prepared by the author based on UNCTAD (2012)

developed and developing countries outside the region are the major sources of FDI for most of the South Asian countries: the top five sources account for about two-thirds of the total FDI flow in South Asia (Table 8.2). Such kinds of concentration of FDI flow reflect the locational disadvantage of other South Asian countries in terms of building horizontal and vertical linkages within the region. Weak intra-regional trade can partly explain this poor situation of regional investment.

Intra-regional FDI accounted for a miniscule share of FDI in most of the South Asian countries. None of the countries except India made a significant outward investment. Although India's outward investment is over US\$15 billion, only a small amount was directed to South Asia (Table 8.3). These investments are mainly targeted at important strategic sectors such as infrastructure building, resource extraction, information technology (IT) and the high-tech sectors of developing and developed countries, where South Asian countries have limited opportunities and potential. India's FDI to Sri Lanka is mainly directed at steel, cement, rubber products, tourism, computer software, IT training and other professional services (Aggarwal 2008) and its FDI in Nepal is mainly in textiles, chemicals, food and beverages, and fabricated metals, etc. Bilateral investment between India and Sri Lanka after the Indo-Sri Lanka Free Trade Agreement (FTA) shows different categories of capital flow, including market-seeking (Sri Lankan Company Brandix's investment in India), resource-seeking (Indian company Ceat's investment in Sri Lanka) and tariff-arbitrage (export of Vanspati).

Most of the countries in the region have not yet fully opened their capital accounts concerning possible adverse effect on the balance of payment. Because of the restriction or partial openness of the capital account, outward FDI flow by local companies has been significantly restrained. A major constraint for outward investment of South Asian countries is to put restrictions over outward flow of capital (Habib et al. 2004).

Table 8.2 Sources of FDI

Country	Year	Top sources of FDI	Share of top five territories (%)	Share of traditional OECD countries (%)*	No. of identified source countries*
India	2010–11	Mauritius, Singapore, USA, Japan and the Netherlands	65.4	27.0	100
Bangladesh	2010–11	UK, USA, Hong Kong, South Korea and Egypt	61.3	51.0	44
Pakistan	2010–11	USA, UAE, UK, Hong Kong and China	57.6	61.0	33
Nepal	2010–11	India, China, South Korea, Japan and Canada	67.0	22.0	25
Sri Lanka	2010	USA, Malaysia and UAE	62.0	NA	NA

Note: *Data for 2006.

Source: Author's estimation based on Aggarwal (2008), Bangladesh Bank (2011), State Bank of Pakistan (2011), Central Bank of Sri Lanka (2010), Kamaladevi (2011)

Table 8.3 Outward flow of FDI from South Asia (US\$ million)

Country	2006	2007	2008	2009	2010	2011
Afghanistan	–	–	–	–	–	–
Bangladesh	4	21	9	29	15	9
Bhutan	–	–	–	–	–	–
India	14,285	19,594	19,257	15,927	13,151	14,752
Maldives	–	–	–	–	–	–
Nepal	–	–	–	–	–	–
Pakistan	109	98	49	71	47	62
Sri Lanka	29	55	62	20	46	50
South Asia	14,427	19,768	19,377	16,047	13,259	14,873

Source: UNCTAD (2012)

8.2.1 Intra- and extra-regional trade in South Asia

Strong interlinkage between trade and investment is considered to be highly important for enhancing regional investment. Since the 1980s, South Asian countries have gradually liberalised their trade regimes and have also signed a number of bilateral, subregional and regional trade agreements both within and outside the region,

which have contributed to the overall increase in trade of South Asian countries – from US\$320 billion in 2005 to US\$938 billion in 2011 (Table 8.4). However, no significant change took place in the direction of trade – the overwhelming share of South Asia's total trade is still directed outside the region. Intra-regional trade has increased at a much slower rate; while extra-regional trade of South Asian countries registered a rise of 20 per cent per year between 2006 and 2010, intra-regional trade increased only at 8.5 per cent per year during the same period.³ A number of factors have contributed to the low level of intra-regional trade, including long sensitive lists, Pakistan's positive list approach to India, non-tariff barriers and similarities in export baskets (Rahman 2010). The rise in bilateral trade of South Asian countries with neighbouring regions (e.g. South East Asia and East Asia) has yet to make a considerable impact in enhancing regional trade in South Asia. However, South Asia's increasing link with broader production networks with East and South East Asian countries could be an important aspect in future co-operation for trade and investment. Thus, the regional trade integration under the South Asian Free Trade Area (SAFTA) should be broadened through effective operation of other subregional integration initiatives, such as the Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation (BIMSTEC) and Bangladesh China India Myanmar (BCIM) Economic Corridor etc. (Table 8.4).

Trade in services in South Asia has registered a considerable rise since the early 2000s. Its share in gross domestic product (GDP) almost doubled between 2001 and 2010, particularly because of the significant rise in India's trade during that period (Table 8.5). Although most countries in the region have experienced a consistent rise in trade in services as a share in GDP, a few of them have experienced deceleration of growth in their service trade, including Nepal and Sri Lanka. South Asia's service trade is contributed to by a large endowment of professionals, skilled workers and unskilled workers, mainly through inward flow of remittances by migrant workers of the region. Despite such positive changes, South Asia's service sector with its large size is still weak in generating large-scale employment. However, the rise in the service sector since the early 2000s has been contributed to by the liberalisation of most of the services sector including telecommunications, energy and financial services, where a significant amount of FDI flow has been directed (Raihan 2008). There was no regional agreement in trade in services until 2010, when South Asian countries signed the SAARC Agreement on Trade in Services (SATIS), taking a positive list approach for further liberalisation and deeper coverage.

8.3 An overview on Foreign Direct Investment-related policies of South Asian countries

South Asian countries have provided various kinds of incentives and supports for attracting FDI under national FDI policies (Table 8.6). In the case of the pre-entry treatment phase, measures include few sectoral bans, limited use of caps on foreign ownership, requirement of screening in specified projects, almost no minimum capital requirement and no locational clause, etc. There is no sectoral ban in Nepal, Sri Lanka and Maldives, while limited levels of ban are practised in Bhutan, India and

Table 8.4 Export and import of SAARC countries

South Asia's trade with	Export				Import			
	2002	2005	2010	2011	2002	2005	2010	2011
World	60,328.9	132,306.8	272,272.3	365,323.8	73,099.0	188,027.7	438,421.1	572,179.9
SAARC	19.4	47.0	137.1	149.7	20.4	45.1	98.6	143.0
<i>% of total trade of SAARC</i>								
India	83.0	75.9	80.9	82.5	78.6	74.9	79.8	80.8
Pakistan		12.1	7.9	6.9		13.3	8.6	7.6
Sri Lanka	7.8	4.7	3.1	2.7	8.3	4.4	2.8	3.4
Bangladesh	3.9	2.7	1.8	1.8	12.6	6.7	6.0	5.5
Nepal			0.3	0.3			1.2	1.0
Maldives	0.2	0.1	0.03	0.02	0.5	0.4	0.2	0.2
Bhutan		0.2	0.2	0.1	0.0	0.2	0.2	0.2

Source: Trade Map Database (2012)

Table 8.5 Trade in services (% of GDP)

	2001	2005	2010	2011
South Asia	7.5	11.5	13.3	
Bangladesh	4.8	5.7	6.8	7.0
India	7.6	12.0	14.3	
Maldives	57.8	54.0	108.9	123.0
Nepal	10.5	10.0	9.6	8.7
Pakistan	5.2	10.2	7.8	6.2
Sri Lanka	19.7	14.9	11.3	12.0

Source: World Development Indicators database 2013

Note: No data are available for Bhutan and Afghanistan

Bangladesh. Most of the South Asian countries impose different levels of caps over FDI taking into account the capacity of domestic investors. Most countries keep the screening provision for new FDIs in order to appreciate the quality on various aspects such as nature of production, nature of employment, its environment friendliness and impact of FDI in the locality, etc. Out of the seven countries reported in Table 8.6, five countries do not follow minimum capital requirement, while the other two countries have such requirements but on a sectoral basis.

In the case of post-entry treatment FDI, measures include, among others, no employment requirement, limited performance requirement, allowing import of technologies, no restriction on repatriation of capital and profits, and provision of different tax incentives (Aggarwal 2008). Despite a general demand for more FDI in labour-intensive industries, no country has imposed any employment requirement as a clause for investment. The same is true for performance requirement although most countries expect better use of local resources by foreign-owned companies. Countries are liberal in cases of technology transfer by the foreign-owned companies, although it is considered to be a major device for the development of technological capacity of developing countries. Evidence suggests that technology transfer by multinational corporations (MNCs) in developing countries is not induced by market-related factors and often transfer is limited due to various factors (Moran et al. 2005). Repatriation of profit and dividend is allowed for foreign companies despite the fact that net inflow of foreign exchanges may be either too low or even negative (Bhattacharya 2004). All countries provide tax incentives to foreign investment in order to encourage them to invest in their country, although its consequences are not always positive in many countries (Moran et al. 2005). Overall, South Asian countries are following liberal FDI policy with conditions at the pre-establishment phase but few at the post-investment phase. However, homogenous policy environments across the region alone cannot ensure similar advantage to all locations, rather, a number of other factors are responsible for ensuring that advantage to different locations.

Most of the South Asian countries have signed bilateral investment treaties with a number of developed and developing countries outside the region (Table 8.7). Within South Asia, such treaties are not so common. These treaties have specific provisions for safeguarding foreign investment in the destination country. Various analyses

Table 8.6 FDI policies of South Asian countries

Criteria	Bangladesh	India	Nepal	Pakistan	Sri Lanka	Bhutan	Maldives
<i>Pre-entry treatment</i>							
Sectoral ban on FDI	Private ownership restricted in four sectors	Nine broad sectors		Alcohol		Positive list of sectors	
Caps of foreign ownership	None	Ownership cap on 16 sectors	FDI prohibited in 23 sectors	100 per cent in all sectors	A negative list of sectors	Maximum 70 per cent equity allowed	Investment >US\$5 million can be wholly owned
Screening	No screening except in telecom, power and mineral	Screening for FDI in specified sectors	Approval from department of industries	No screening except in five manufacturing sectors	Strict screening by Board of Investment	Screening by FDI committee which meets once in three months	Mandatory screening if foreign equity is >51 per cent; Conditional screening if it is <51 per cent
Minimum capital requirement	None	None	None	Agriculture: US\$0.3 million; Infrastructure: US\$0.3 million; IT and Telecom: US\$0.15 million	None	Manufacturing: US\$1 million; Services: US\$0.5 million	None
Location	None	None	None	None	None	None	None

(continued)

Table 8.6 FDI policies of South Asian countries (continued)

Criteria	Bangladesh	India	Nepal	Pakistan	Sri Lanka	Bhutan	Maldives
<i>Post-entry treatment</i>							
Employment performance requirement	None	In the small-scale sectors	None	None	None	Restricted	None Use of local content encouraged
Technology imports	None	None	Subject to approval	Limits in agriculture and services	None	Subject to approvals	None encouraged
Restrictions on repatriation of capital and profits	None	None	Subject to approval	None	None	Subject to restrictions	None
Tax incentives	Tax incentives on expatriate incomes	Non-discriminatory	Non-discriminatory	50 per cent on plant and machinery and depreciation	Non-discriminatory	Non-discriminatory incentives	Foreign investors have to pay royalty to the government

Source: Aggarwal (2008)

Table 8.7 Bilateral investment treaties signed by South Asian countries

Country	1980	1985	1990	1995	2000	2011
Bangladesh	1	1	8	8	12	19 (0, 3)
India	0	0	0	1	13	33 (1, 4)
Nepal	0	1	2	3	3	4 (0, 3)
Pakistan	2	4	7	10	15	23 (1, 4)
Sri Lanka	4	13	16	17	20	23 (2, 4)
Afghanistan						3
Total	7	19	33	39	63	105

Note: Figures in the parentheses indicate number of bilateral investment treaties and avoidance of double taxation treaties signed within South Asia.

Source: Banga (2003) and author's calculation

show that bilateral investment treaties signed by South Asian countries have limited impact in attracting FDI to the region (in the case of Bangladesh, see Bhattacharya 2004; Bhattacharya and Moazzem 2006).

Imposing different kinds of restrictions over bilateral investment is a major factor for low level of investment in South Asia. India has put restrictions on the investment of Pakistan and Bangladesh. However, a number of developments took place in the political arena, under which India has recently withdrawn restrictions over Bangladesh's investment at limited scale. The development of an India–Pakistan relationship would make way to withdraw restrictions over Pakistan's investment in India.

It is clear from the above discussion that South Asian countries are yet to give adequate attention to enhancing regional investment. Policies and measures for regional investment co-operation in South Asia have experienced marginal development compared with those related to trade integration. More importantly, promotion of intra-regional investment seems to be considered mainly through promotion of trade between South Asian countries. Regional co-operation for investment has yet to be considered as a major policy instrument for strengthening regional integration.

8.4 Institutional approach for enhancing regional investment: An analysis of SAARC initiatives

SAARC was the main body to take initiatives towards enhancing intra-regional investment in South Asia. However, SAARC initiatives were often found to be little and sporadic. During the 1980s and early 1990s, SAARC initiatives for promotion of FDI were largely absent, perhaps because of the low level of global flow of FDI at that time (Table 8.8). With the rise in the global flow of FDI in the 1990s, SAARC put emphasis on encouraging extra-regional FDI. Malé SAARC

Table 8.8 SAARC declarations on promotion of regional investment

Summit	Venue and year	Status of mention	Major highlights
First	Dhaka, 1985	No mention	
Second	Bangalore, 1986	No mention	
Third	Kathmandu, 1987	No mention	
Fourth	Islamabad, 1988	No mention	
Fifth	Malé, 1990	No mention	
Sixth	Colombo, 1991	No mention	
Seventh	Dhaka, 1993	<ul style="list-style-type: none"> The Heads of States or Governments noted the importance of adequate investment in the health and education sectors for the success of their population programmes They observed that the economies of developing countries continued to suffer as a result of limited market access for their exports, dwindling resource flows, absence of adequate foreign investment, mounting external indebtedness, inadequate transfer of technology and inequities in the global monetary, financial and trading systems Referring to the competing demands for capital investment resources, the Heads of States or Governments underscored the need to ensure the adequate flow of investment resources to the developing countries through increasing global savings and a more equitable utilisation of the peace dividends 	<ul style="list-style-type: none"> Extra-regional FDI stressed
Eighth	New Delhi, 1995	No mention	

(continued)

Table 8.8 SAARC declarations on promotion of regional investment (continued)

Summit	Venue and year	Status of mention	Major highlights
Ninth	Malé, 1997	<ul style="list-style-type: none"> The Heads of States or Governments agreed that the efforts to enhance trade and economic co-operation in the region would be further strengthened by initiating specific steps to promote and protect investment, increase complementarities in economic activities of member states and other measures supportive of promotion of SAARC joint ventures They also welcomed the offer of India to host a meeting on promotion and protection of investment and the offer of Pakistan to host a meeting on avoidance of double taxation They also welcomed measures of co-operation in the areas of customs standardisation, arbitration and enhancing industrial economy and management The Heads of States or Governments reaffirmed their determination to encourage the private sector in the region to contribute increasingly to the strengthening of intra-SAARC links in key areas of trade, investment and finance They welcomed the decision by the SAARC Chamber of Commerce and Industry (SCCI) to convene annually an Economic Cooperation Conference in conjunction with the annual meeting of SAARC Commerce Ministers and SAARC Trade Fairs The Heads of States or Governments called on the developed countries to assist the developing countries through the creation of a favourable and supportive global economic environment, in particular, through domestic action in their countries for purposes of accelerated investment flows to developing countries, thereby generating a positive impact on the developmental efforts of developing countries as well as assisting their integration into the multilateral trading system 	<ul style="list-style-type: none"> Promotion and protection of intra-regional investment stressed Domestic measures of developed countries to enhance investment in developing countries

(continued)

Table 8.8 SAARC declarations on promotion of regional investment (continued)

Summit	Venue and year	Status of mention	Major highlights
Tenth	Colombo, 1998	<ul style="list-style-type: none"> Increased opportunities in trade and investment have bypassed many developing countries. The least developed countries (LDCs) have in particular been marginalised through a series of developments including the shrinking of official development assistance (ODA), concessional and other financial flows to these countries The Heads of States or Governments cautioned that potential efforts to formulate a new multilateral investment agreement should not overlook the need to ensure the continued independence of developing countries and LDCs to formulate specific investment policies appropriate to their stage of development They acknowledged the need to enhance the collective capacity of SAARC in respect of policy analysis, with a specific emphasis on international financial, monetary, trade and investment issues and their domestic ramifications The Heads of States or Governments agreed that the benefits of economic liberalisation would be more extensive and better balanced through the promotion of trade-creating joint ventures, investment and trade in services such as tourism 	<ul style="list-style-type: none"> Multilateral investment agreement should provide scope to LDCs and developing countries to formulate specific investment policy Building analytical capacity at regional level
Eleventh	Kathmandu, 2002	<ul style="list-style-type: none"> The Heads of States of Governments agreed to accelerate co-operation in the core areas of trade, finance and investment to realise the goal of an integrated South Asian economy in a step-by-step manner The Heads of States of Government also decided to instruct the Secretary General to facilitate the early finalisation of a regionally agreed investment framework to meet investment needs of the SAARC member states The Heads of States of Government acknowledged that investment in poverty alleviation programmes contributes to social stability, economic progress and overall prosperity 	<ul style="list-style-type: none"> Finalisation of regional investment framework stressed

(continued)

Table 8.8 SAARC declarations on promotion of regional investment (continued)

Summit	Venue and year	Status of mention	Major highlights
Twelfth	Islamabad, 2004	<ul style="list-style-type: none"> Investment in human resources is critical for future development of South Asia. It is, therefore, essential to establish a network of centres of higher learning, training and skill development institutes across South Asia 	<ul style="list-style-type: none"> Investment in human resources
Thirteenth	Dhaka, 2005	<ul style="list-style-type: none"> The Heads of States of Government recognised the need to take the process of regional economic integration further by expanding the scope of SAFTA to include trade in services, enhanced investment and harmonised standards 	<ul style="list-style-type: none"> Acceleration of trade in services and investment under SAFTA framework
Fourteenth	New Delhi, 2007	<ul style="list-style-type: none"> Heads of States of Government stressed that to realise its full potential, SAFTA should integrate trade in services. They called for finalisation of an agreement in the services sector at the earliest. They also directed that the Agreement on Investment Promotion and Protection be finalised 	<ul style="list-style-type: none"> Finalisation of Agreement on Investment Promotion and Protection stressed
Fifteenth	Colombo, 2008	<ul style="list-style-type: none"> Towards achieving further economic integration, they directed that the Draft Agreement on Investment Promotion and Protection be finalised early and the SAARC Arbitration Council be operationalised 	<ul style="list-style-type: none"> Finalisation of Agreement on Investment Promotion and Protection stressed Operationalisation of SAARC Arbitration Council

(continued)

Table 8.8 SAARC declarations on promotion of regional investment (continued)

Summit	Venue and year	Status of mention	Major highlights
Sixteenth	Thimphu, 2010	<ul style="list-style-type: none"> The leaders emphasised the need to strengthen the role of the private sector in regional initiatives through appropriate mechanisms including through public-private partnership (PPP) as well as the need for greater intra-SAARC investment promotion efforts The leaders underlined the important role of the SAARC Development Fund (SDF) for financing regional and subregional programmes and projects. They welcomed the ratification of the SDF Charter. The leaders also welcomed the inauguration and operationalisation of the Permanent Secretariat of the SDF including the appointment of its first Chief Executive Officer (CEO). The leaders also urged the importance that projects funded through SDF be demand-driven, time-bound and aligned with the developmental priorities of the region. The leaders also emphasised the need for the member states to take full advantage of the mechanism of the SDF through expeditious clearance and implementation of the projects and programmes to promote the welfare of the people of the SAARC region, to improve their quality of life and to accelerate economic growth, social progress and poverty alleviation in the region 	<ul style="list-style-type: none"> Strengthening of the role of private sector through greater intra-regional investment promotion efforts Ratification of the SAARC Development Fund for financing regional and subregional programmes and projects
Seventeenth	Addu City, 2011	<ul style="list-style-type: none"> To direct the SAARC finance ministers to chart a proposal that would allow for greater flow of financial capital and intra-regional long-term investment To make available an appropriate percentage of national income towards the respective countries' renewable energy investments, subject to the approval of national arrangements 	<ul style="list-style-type: none"> Proposal for greater flow of financial capital and inter-regional long-term investment Investment in renewable energy

Source: Prepared by the author based on the SAARC Declarations. see: www.saarc-sec.org/SAARC-Summit/7/ (accessed 21 May 2014).

declarations in 1997 urged developed countries to take domestic measures for encouraging investment in South Asia. During the 1980s and 1990s, most of the SAARC countries had not opened their capital accounts and not allowed the outward transfer of capital on a large scale. As a result, initiatives for promotion of investment in South Asia were largely confined to attracting extra-regional investment in South Asian countries.

A major policy focus of SAARC initiatives was the promotion of trade-led intra-regional FDI. As a result, a major part of the SAARC initiatives for economic co-operation in the 1990s and early 2000s was largely confined to promotion of regional trade co-operation – at first by establishing the SAARC Preferential Trading Arrangement (SAPTA) in 1995, and then by establishing the South Asian Free Trade Area (SAFTA) in 2006. There was no broad discussion on the promotion of investment during this period outside the purview of trade co-operation within the region. Discussion on regional co-operation for investment was confined to the preparation of draft acts for promotion and protection of intra-regional investment. This was implemented perhaps with the assumption that with the enactment of SAFTA, intra-regional investment would automatically be increased.

The most concrete initiative so far made under the aegis of SAARC is to draft an agreement on the promotion and protection of investment from regional countries. The major objective of the agreement is to ensure equal treatment for investments of SAARC countries without restriction, quota and marketing. Products of such investments will not be listed under the sensitive list, in order to promote cross-border trade and investment. However, the draft agreement has been pending approval since 2007. During the Seventeenth SAARC Summit, held in Maldives, a fast-tracking of the regional investment treaty was called for, along with the creation of regional production chains, in order to deepen linkages in the SAARC region.

SAARC initiatives for the promotion of investment need to take into account a number of characteristic features of the region, particularly with regard to the domestic production base, production network, and intra-regional and extra-regional investment. First, FDI in South Asia is mainly targeted toward local markets, particularly domestic market-oriented manufacturing and services-related industries. Thus, intra-regional trade would have few implications on the promotion of regional flow of FDI. Second, South Asia is part of global production networks linked with countries outside the region. Thus, promotion of an exclusive regional production network would not be attractive to the foreign investors, including those from the region. Third, since foreign investors outside South Asia predominate in FDI in most of the South Asian countries, promotion of extra-regional investment should be equally considered or at least should not be adversely affected through other measures. Fourth, with the rise of the global flow of financial capital, South Asian countries need to consider further relaxation of the capital account in order to enhance regional flow of capital. In the SAARC Summit, held in Addu City, Maldives, in 2011, regional flow of financial capital was stressed, along with the promotion and protection of investment. Thus there is scope for taking initiatives beyond the

traditional framework of regional investment co-operation in South Asia. Future institutional frameworks for investment should cater to multidimensional aspects of investment co-operation both within and outside South Asia.

The SAARC Development Fund (SDF), which started its operation in 2010 with an initial capital of US\$300 million, is mandated to finance development projects in social, economic and infrastructure-related projects. Initially, it provided finance to social sector projects, such as strengthening the livelihood initiative for home-based workers in the SAARC region; strengthening maternal and child health including immunisation; scaling up of zero energy cold storage (ZECS) technology for the horticultural commodities in the high hills of SAARC countries; empowering rural communities 'reaching the unreached'; conducting a study on teacher development as the key to enhancing the quality of basic education in selected SAARC countries; and strengthening the livelihood initiative for home-based workers in SAARC region (Phase-II) and the South Asia Initiative to End Violence Against Children (SAIEVAC).⁴ The other two components of the Fund, such as economic and infrastructure-related projects, have not yet been initiated. The overall objective of the Fund is to improve quality of life, promote welfare and accelerate economic growth, social progress and poverty alleviation in the SAARC region. In these regards, the Fund promotes cross-country initiatives. The Fund is mandated to promote social and economic projects instead of commercially viable investment projects. Hence, despite its prospect in terms of facilitating cross-border flow of funds, it would contribute little towards enhancing large-scale intra-regional FDI.

In 'effective' terms, there is no independent separate body in the institutional structure of SAARC to deal with investment-related issues. The inter-ministerial committee for trade discusses and takes decisions on investment-related issues apart from its core activities related to trade. As the committee has to spend a substantial amount of time discussing trade-related issues, investment issues have been discussed very sporadically and particularly on a need basis. Such an approach to investment co-operation makes the issue dependent on the progress made in trade integration within the region. Given the gravity of the issue of investment co-operation both within and outside the trade-investment nexus, a separate body in the SAARC needs to be formed to deal the relevant issues.

8.5 Experience of ASEAN towards enhancing regional investment: Learning for SAARC

SAARC can take lessons from ASEAN with regard to the initiatives undertaken for the promotion of investment in South East Asia. Although there is huge difference between the two regions in terms of size of the economy, level of economic development and level of integration, the success of ASEAN would be a good learning experience for the SAARC region. A major characteristic of ASEAN initiatives is to promote investment along with trade, both within and outside the region.

Under the institutional framework of ASEAN, investment co-operation between South East Asian countries has evolved over the years with a view to promote

both intra- and extra-regional investment. In 1987, ASEAN countries signed an agreement on the promotion and protection of investment.⁵ In a continuation of this process, a framework agreement on the ASEAN Investment Area (AIA) was signed in 1998 with a view to promote ASEAN as an investment area, to strengthen and increase the competitiveness of ASEAN economic sectors, and to work on the reduction of investment barriers in order to enhance investment.⁶ Over time ASEAN members have joined in the Agreement on the AIA. The major focus under the AIA is to implement co-ordinated ASEAN investment co-operation and facilitation programmes, to implement a co-ordinated promotion programme and investment awareness activities, to grant national treatment facilities, to ensure active involvement of the private sector in the AIA development process, to provide a more streamlined and simplified investment process, and to eliminate investment barriers and liberalise investment rules and policies. To oversee the implementation of the AIA framework agreement, a ministerial-level ASEAN Investment Area Council was established which was assisted by the ASEAN Coordinating Committee on Investment. In 2009, ASEAN further widened investment co-operation by signing the Comprehensive Investment Agreement.

Despite the progress made in the institutional arrangement of AIA, its impact on FDI flow in South East Asia is mixed. The key instrument of the AIA is to liberalise investment provisions for most of the industries for the investors of the ASEAN region except for four categories of industries. According to Jarvis, Shaofeng and Boon (2009), most countries have restricted investment to a number of key strategic sectors under the AIA with a view to protecting domestic investment. These sectors include telecommunication, financial services, infrastructure, transport and print, electronic and broadcast media, etc. Moreover, member countries impose various conditionality clauses which make investment access difficult in the sectors liberalised under the AIA including ceiling in equity participation, joint-venture clause, forced government business co-operation contracts, directed sourcing contracts, domestic market access restrictions, export-only clause, etc. (Jarvis et al. 2009). Thus a wide discrepancy is found in terms of provisions as per the AIA and that is followed at national level by member countries. In that context, ASEAN member countries have to undertake various liberalisation initiatives in order to make the AIA more effective for regional investors.

Besides various initiatives undertaken at government to government levels, a number of private sector initiatives have been carried out among regional investors including the ASEAN Industrial Joint Venture (AIJV) and the Brand-to-Brand Complementation (BBC) schemes and ASEAN Industrial Cooperation (AICO) scheme, etc. Given the limitations of the first two approaches, the third initiative is that AICO is currently particularly focusing on investment schemes to be promoted through tariff and non-tariff incentives (e.g. preferential tariff of 0–5 per cent for products manufactured by participating companies).⁷ Under the AICO, ASEAN companies could undertake joint-venture initiatives in the manufacturing sectors. Such arrangements facilitate physical movement of products between participating companies, as well as encouraging resource sharing/pooling and/or industrial complementation.

ASEAN investment co-operation both at inter-governmental level as well as in the private sector is being pursued for greater integration in the regional production network. In order to integrate trade, investment and production-related activities within the region, it has put emphasis on three core integration schemes including AIA, AFTA and the AICO scheme. Such integration of investment-related schemes under strong trade integration between countries could facilitate greater regional integration and make the regional production networks more competitive.

Investment in the ASEAN region has been enhanced by Japanese FDI, as it takes a lead role in promoting intra-regional investment. Japanese TNCs have developed vertical and horizontal production networks in the region which facilitate investment. South Asia needs this kind of investment in the region which takes a lead role for the development of a production network targeting the regional and global markets.

The institutional mechanism followed in the ASEAN region is definitely a learning model for SAARC. However, its replication in SAARC region is not so easy, particularly because of the lack of preparedness of SAARC to address core challenges such as low trade integration, limited market size, the weak intra-regional production network, lack of infrastructural facilities and insufficient human resources. However, ASEAN initiatives could provide directives to SAARC for the promotion of regional investment.

8.6 Suggestions for accelerating SAARC's institutional initiatives for enhancing intra-regional investment in South Asia

SAARC Secretariat is the official body that pursues investment-related initiatives through a Trade and Investment Sub-committee. Given the importance of regional investment co-operation in South Asia's economic growth and its growing link with trade and non-trade issues, SAARC should consider forming a separate sub-committee with specific terms of reference to deal with investment-related issues. This committee should identify a possible mechanism for enhancing regional investment and should set a work plan with a specific timeline for implementing various activities. One of the major activities of the proposed sub-committee would be to work out an effective mechanism to ensure regional capital flow in order to enhance investment in potential sectors in different South Asian countries.

A major constraint for prospective regional investment is very limited knowledge about investment potential in different SAARC countries, particularly lack of information – for example on regional markets, sectors, investors and facilities. Various studies have identified potential sectors at regional level where a regional value chain could be developed (Aggarwal 2008; Moazzem 2005) (Table 8.9). In this context, each country should make information accessible to the investors through national-level investment-promoting agencies.

Given the importance of extra-regional FDI for the development of South Asia, SAARC initiatives should continue to provide necessary incentives and support

Table 8.9 Priority industries for investment in South Asian countries

Pakistan	Value-added export industries: manufacturing categories such as garments, bed linens, surgical instruments, and sporting goods High-tech and IT industries: chip manufacturing, software development and precision equipment manufacturing Others: tourism, housing, engineering, chemicals and construction
Bangladesh	Textiles, electronics, IT, natural gas-based industries, frozen foods, leather, ceramics, light engineering and agro-based production
Nepal	Medicinal and aromatic plants, agro-based (mushroom, spices, vegetables, fruits), dairy, tea, sericulture, hydropower, leather, poultry and textiles
Sri Lanka	Electronics, light engineering, textiles, rubber, mineral and processing, tourism, IT, gems and jewellery, healthcare and pharmaceuticals, ceramics and services
Bhutan	Hydropower, agro-processing, tourism and medicinal plants
Maldives	Marine-based industries, tourism, infrastructure, and air and sea transport

Source: Aggarwal (2008)

for that. ASEAN experience shows that both intra-regional and extra-regional investments should be treated equally, and should be promoted with equal emphasis. Thus SAARC should work on regional investment promotion taking broader and long-term issues into consideration.

A number of initiatives are currently under discussion and at the phase of implementation at the SAARC, which if completed successfully, could facilitate intra-regional investment in South Asia. These include, among others, establishment of an SAARC Arbitration Council, SAARC limited multilateral agreement on avoidance of double taxation and mutual administrative assistance in tax matters. Operationalisation of these agreements and institutions would help to increase trade and investment in South Asia. SAARC should put emphasis on timely completion of these agreements.

SAARC Chamber of Commerce and Industry (SCCI) has been formed to enhance trade and investment, to safeguard economic and business interests of SAARC, and to promote the exchange of commercial and industrial management, and scientific information, education and know-how among the member countries. This private sector trade body is pursuing broader investment co-operation in South Asia through the creation of awareness-building activities in the business communities. A major area of interest of the SAARC Chamber is to develop an institutional framework for supporting economic co-operation. SCCI should facilitate regional investment by facilitating investors at the pre-establishment phase by providing important market-related information.

Awareness building for enhancing intra-regional investment should be expedited through the initiative of the private sector trade bodies both at local and regional levels. SAARC Chamber has to play a proactive role in this direction. According to the Asian Development Bank and Federation of Indian Chambers of Commerce and Industry (2010), intra-regional investment has been constrained by restrictive policies, such as excluded sectors, equity restrictions, lack of sufficient protection

for investors, under utilisation of bilateral investment treaties and lack of strategic promotion of intra-regional investment. In this context, the Chamber has suggested the following proposals: opening up the excluded sectors on a limited basis; allowing FDI for those sectors in specific cities; expansion of the use of bilateral investment treaties and harmonisation of investment provisions in FTAs; promoting more intra-regional investment through boards of investment; establishing dedicated country offices; expanding the marketing strategies and targeting the priority sectors; and conducting a feasibility study on creating an umbrella investment body for South Asia. In this context a separate institutional structure is needed in order to enhance regional investment.

Trade-led FDI will play a major role in the coming decade, particularly India's ongoing endeavour for building economic co-operation both within and outside the region. In this context further tariff liberalisation under the SAFTA accord, particularly reduction of member country's sensitive lists, would contribute to the enhancement of regional trade. Such tariff liberalisation would have direct implications on intra-regional investment in South Asia. Besides, ongoing discussions on a number of bilateral trade agreements between South Asian countries might facilitate investment in the future. Moreover, a number of subregional initiatives (e.g. BIMSTEC) are ongoing. Extra-regional initiatives such as the India-ASEAN, India-EU and India-Mercusur trade agreements would have direct implications on extra-regional investment in South Asia, particularly in India. Analysis shows that such agreements will have an adverse impact on small countries (CARIS 2008). Moreover, financial capital would also be invested within the region which needs to be accommodated in the framework for investment co-operation in South Asia.

8.7 Conclusion

South Asia is one of the lowest FDI recipient regions in the world despite the fact that its FDI regime is one of the most liberalised regimes in the world. Except India, none of the countries of the region could attract a considerable amount of FDI every year. More importantly, intra-regional FDI is not the major source of FDI in most of these countries. Extra-regional sources predominate in regional trade and investment. In other words, weak regional integration is one of the major stumbling blocks for strengthening regional investment co-operation in South Asia.

Regional co-operation for investment is not yet becoming a priority agenda in the SAARC initiative. Various activities related to investment co-operation are miniscule and sporadic in nature with little impact on the promotion of regional investment. Most importantly, initiatives for investment co-operation are considered 'supplementary' to those of trade-related initiatives. Given the importance of co-operation for regional investment, there is scope for undertaking investment-focused initiatives in SAARC's institutional structure, particularly when trade integration is yet to be strengthened at the regional level.

It is understandable that South Asia is quite backward compared with other regions in terms of undertaking institutional measures targeting investment co-operation.

A good learning model for SAARC could be ASEAN. Various measures have been undertaken at government level over the years, of which the latest are the AIA and the Comprehensive Investment Agreement. Moreover, a number of private sector initiatives are in operation for the promotion of intra-regional investment of which the most recent is the ASEAN Industrial Cooperation (AICO) scheme. In order to strengthen the regional production networks and make them globally competitive, ASEAN has recently begun to integrate a number of government-level and private-level initiatives. South Asia could take lessons from those ASEAN initiatives for regional investment co-operation. Similar to Japan in the case of promoting intra-regional investment in South East Asia, one or two major FDI sourcing countries with an interest to investment in South Asia could take the lead role to enhance bilateral and regional investment with a view develop production networks within the region.

South Asian countries should work toward building production networks in different sectors using intra- and extra-regional trade and investment. This could be done under the aegis of the institutional structure of the SAARC. In this context, a separate independent body is to be formed focusing on the promotion of intra-regional and extra-regional investments. The Committee will work with the government of the member countries as well as with the private sector trade bodies to introduce new policies and to undertake measures and action plans for increasing regional FDI. The Committee should take initiatives to identify barriers to investment within the region, support private sector with market-related information and set the agenda for discussion in the SAARC Summit with a view to strengthening regional investment co-operation in South Asia in a sustained manner.

Notes

- 1 The author would like to thank the participants of the International Conference on 'Regional Trade and Economic Cooperation in South Asia: Trends, Challenges and Prospects' held in New Delhi on 2–3 May 2013 for their valuable comments on this chapter. The Conference was organised by the Research and Information System for Developing Countries (RIS), India and the Commonwealth Secretariat, London. Some of the issues discussed in the chapter are also reflected in another paper of the author (Moazzem 2012).
- 2 An investment creation in an integrated regional market could be a good substitute of possible 'trade diversion' in the region (Bloström and Kokko 1997).
- 3 India is the major trading partner for most of the South Asian countries.
- 4 A number of projects are in the pipeline which include access to water in SAARC countries; regional inter-professional master's programme in rehabilitation science; establishment of toll-free helplines for women and children; and post-harvest management and value addition of fruits in production catchments in SAARC countries.
- 5 This act was amended in 1996.
- 6 In 2001, a protocol was signed to amend the framework agreement.
- 7 The AICO scheme allows joint-venture of participating companies which operate at different stages of the production value chain including raw materials, intermediate products and final products. Produced products of the participating companies will enjoy different levels of market access in the respective companies' market depending on at what stage the products are produced – from 0–5 per cent in the case of raw materials and intermediate products to unlimited access in the case of final products. (For details see: www.asean.org/communities/asean-economic-community/item/asean-industrial-cooperation-scheme).

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