Attracting Foreign Direct Investment

What Can South Asia's Lack of Success Teach Other Developing Countries?

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Abstract

Like many other developing countries, South Asian nations have been experiencing increased foreign direct investment inflows over the past decade as developing countries get a larger share of cross-border investments that were once sent to developed countries. Nonetheless, South Asia's inflows of foreign direct investment remain the lowest relative to gross domestic product among developing country regions. Why are South Asia's foreign direct investment inflows so low and what lessons can be drawn for developing countries as a whole? The analysis in this paper uses a novel empirical model that accounts for possible trends in convergence in the ratio of foreign direct investment to gross domestic product between countries and cross-sectional data for 78 countries from 2000 to 2011. The sample contains 52 developing countries. The analysis finds that two key factors are at work—high overall regulatory restrictions on foreign

direct investment and specific restrictions placed on doing business with other countries. These factors include overall trade restrictiveness, which reduces the benefits to cross-border investments, and weak institutions to protect foreign investors and facilitate investment. Nonetheless, the potential for faster growth in intra- and inter-regional foreign direct investment flows is significant. The main factors leading to this conclusion are South Asia's current low levels of foreign direct investment, the many unexploited opportunities for embodied knowledge transfer, and supply-chain linkages. The overall lessons for developing countries are that liberalizing policy constraints in both trade and foreign investment, keeping corporate tax rates modest, and improving governance and transparency could help to substantially improve foreign direct investment flows.

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Introduction

Like many developing countries, countries in South Asia are experiencing a youth bulge entering the labor market. To absorb these workers (1 million per month for the next 20 years in the case of South Asia), provide higher living standards and reduce poverty, these economies will have to rely on more than just public investment.⁴ It's just not feasible to provide all the economic capacity for more and better jobs through the government sector at a time when budgets are already under pressure and debt levels are relatively high. The private sector will have to play a key role in creating productive jobs for the new labor force entrants, and a critical element of this is improving the economic climate to attract private investment, a vital factor in sustainable and broad-based growth.

While greater domestic private sector investment is important, no country has moved into middle-or upper-income status in isolation. Foreign private capital flows—bank lending, direct investment and portfolio investment (i.e., debt and equity)—expand the potential sources of capital available to countries, raising productivity and boosting growth. Studies find that foreign direct investment (FDI) has a potentially large role due to its relative stability (Levchenko and Mauro 2007) and its impact on transfers of knowledge and technology (Moran, Graham and Blomström 2005).⁵ Empirical evidence points to FDI's productivity-enhancing effects in advanced economies—on average a 1.3 percent increase in country-wide total factor productivity growth has been associated with a 10 percent increase in FDI—although the impact varies by country (Bitzer and Görg 2009). Other research indicates similar outcomes in developing countries: the Czech Republic and Russia (Sabirianova Peter, Svejnar and Terrell 2005), Indonesia (Blalock and Gertler 2004), Lithuania (B. S. Javorcik 2004), among others. Blonigen and Wang (2005) find that FDI flows to developing countries, as opposed to developed countries, have a particularly strong effect on growth by crowding-in domestic investment. Kee (2011) shows that direct and indirect

⁴ The South Asia region refers to Afghanistan, Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, and Sri Lanka.

⁵ The IMF's most recent Balance of Payments Manual (BPM6) defines FDI as "a category of cross-border investment associated with a resident in one economy having control or a significant degree of influence on the management of an enterprise that is resident in another economy." This is operationally defined as having at least a 10 percent equity stake in the foreign firm. Inward FDI refers to foreign investment flows into the home countries, whereas outward FDI is the countries' investment flows to other countries. FDI is classified by two types: (1) greenfield investment involves constructing new operational facilities (factories, machinery, etc.) from the ground up and (2) mergers and acquisition (M&A) involve foreign firms acquiring existing assets from local firms. Our analysis in this study will cover both types of FDI together, although the literature has sometimes made a distinction between these two entry modes of FDI in terms of their impact on productivity, growth, and jobs. Some empirical studies suggest that greenfield investment and M&As are not perfect substitutes (Blonigen 1997; Nocke and Yeaple 2007 and 2008; and Norbäck and Persson 2008; Bertrand, Hakkala and Norbäck 2012). The choice of entry modes may influence FDI performance and the host country's performance through research and development (R&D), localization of supplies and human resources, and technology transfers. In fact, a group of studies including Calderón, Loayza and Servén (2004), Kim and Zhang (2008), Wang and Wong (2009), Neto, Brandão and Cerqueira (2010) and Harms and Méon (2011) argue that greenfield has bigger welfare impacts on the host countries via increasing capital formation and productivity.

spillovers can be quite strong, as demonstrated by the case of Bangladesh, where FDI inflows impact both domestic intermediate input suppliers that provide raw material to FDI firms, through increase in demand for high-quality intermediates, and domestic final good producers who are users of those high-quality intermediates as a result of *shared supplier spillover*. While there has been some debate in the popular press as to whether FDI, such as multi-brand retailing in India, would add much to the productive capacity of the country or just capitalize on monopsony power and open the door to greater corruption, studies suggest that corruption itself is a deterrent to FDI.⁶ Indeed, the appeal of attracting more FDI may promote better governance by enticing governments to improve transparency.

This study looks into the historical patterns of FDI to developing countries, examines its sectoral composition, and evaluates current policies and policy options that may help create an environment for increasing FDI flows. The launching point for this study is the experience of South Asia and the substantial empirical literature that suggests that FDI is associated with growth, development, and productivity enhancement. The goal of the study is modest in that it does not seek to estimate the size of FDI spillovers on productivity growth, or address whether governments should actively subsidize FDI inflows over domestic investment as a means to enhance growth, but rather to understand the determinants of FDI flows as a share of GDP, taking South Asia as focal point due to its low current levels, despite the region's relatively high GDP growth over the last decade.

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

By examining the historical patterns of South Asia's FDI, the policy environment, and the connections between the two, this study will provide the context for policy makers in South Asia and other developing countries to identify strategies, ease constraints to FDI, and boost potential

⁶ For example, interview with Joseph Stiglitz, *The Times of India*, October 21, 2012 and the work of Hellman, Jones and Kaufmann (2002) and Golberman and Shapiro (2003).

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

We begin the analysis by documenting the trends in FDI and its potential determinates. We show that FDI (both inward and outward) has grown quite substantially over the last decade for all developing countries and FDI dominates portfolio flows as a source of investment for developing countries. Moreover, FDI inflows have been relatively more stable than portfolio inflows.

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

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

Finally, the paper examines the determinants of FDI growth in South Asia. We find that there is a high potential for larger flows due to South Asia’s current low levels of FDI, as well as opportunities for liberalizing policy constraints in both trade and foreign investment. Lowering corporate tax rates and

improving governance and transparency would also be important contributors to increasing the growth in FDI/GDP. Making progress on all of these areas could help to substantially improve FDI flows into South Asia and enhance the region's growth and productivity, as indicated by the experience of other regions.

Global FDI and South Asia's FDI Experience

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

Developed countries continue to be major source of FDI to developing countries, although the trend is changing as more FDI moves between the developing countries themselves. Except for a few brief periods, portfolio flows (both debt and equity) and bank lending have exceeded FDI for the world as a whole during the past two decades. However, FDI has risen to dominate all flows to developing countries (Figure 1). FDI inflows have also been a relatively stable form of investment. As a source of capital flows, FDI may exhibit lower volatility than other types of capital flows, such as debt and portfolio equity. The stability of FDI is especially relevant during "sudden stops," or interruptions on capital flows. Capital flows skewed toward non-FDI types, such as bank lending and portfolio investments, may lead to increased vulnerability to economic shocks. This pattern certainly played out in South Asia during the global financial crisis that began in 2008 (see chart below). Regardless of the source of capital flows, significant volatility suggests that there is room for countries to invest in institutions and programs that would help reduce their populations' vulnerability to increased exposure to global (and regional) economic shocks.

Growing international capital flows have become an increasing share of employment in developing countries, including those in the South Asia region. Globally, employment in wholly or partly foreign-owned companies has increased in the recent years, accounting for 69 million jobs in 2011, an 8 percent increase over the previous year. By contrast, overall job growth in the same period was 2 percent (UNCTAD 2012).

Figure 1: Foreign Direct and Portfolio Investment Inflows

Source: BOP, IMF

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

Figure 2: Inward FDI Flows, 1995-2010

Figure 3: Outward FDI Flows, 1995-2010

Since the 2008-09 global financial crises, developing countries' increasing importance has become even more pronounced in global FDI flows—both inward and outward. Stress in global financial markets, risk aversion, and uncertain profits made it more difficult to finance M&A across the globe. In this tough environment, FDI inflows actually contracted more in developed countries than in developing ones. In 2007-09, developed countries' inward FDI flows declined 53.9 percent, while flows to the developing countries fell by only 12.3 percent.⁷

To a large extent, trends in global outward FDI flows mirror inward FDI flows. Outward flows from developed countries experienced a 46.2 percent decline in 2007-10. Outward FDI flows from developing countries also fell over the same period—but by just 8 percent. While FDI outflows have slowly begun to recover globally, they bounced back quite strongly in developing countries and reached 21 percent of total world FDI at the start of 2011.

The Global Context: Despite Fast Growth, South Asia's FDI Is Low

South Asia's FDI inflows as a share of GDP are among the lowest of all developing regions and can be a good case study to examine for other regions and countries confronting low FDI.⁸ South Asia is one of the world's fastest growing regions, averaging 6.7 percent annual increases in real GDP over the past decade (Figure 4, left).⁹ However, South Asia's FDI inflows as a share of GDP are the lowest of all developing regions, averaging less than 2 percent in 2000-11 (Figure 4, right).¹⁰ Although the gap had been narrowing, it reversed somewhat after the global crisis. South Asia's economy is almost twice as large as Sub-Saharan Africa's; yet over the 2000-11 decade, South Asia's average annual inward FDI flow of US\$18.3 billion was smaller than Sub-Saharan Africa's US\$19.4 billion.

⁷ In this report, developing economies include both developing and transitional economies as defined in UNCTAD.

⁸ "FDI inflows" are defined as net investments in domestic firms by foreigners. This is a different concept than "net" FDI (net investment in domestic firms by foreigners minus the net purchases of foreign firms by domestic agents). (Broner, et al. August 2011) find that "gross" capital flows tend to be more volatile than "net" capital flows. When foreigners invest in a country, domestic agents tend to invest abroad, and vice versa. Gross capital flows are also pro-cyclical, with foreigners investing more in the country and domestic agents investing more abroad during expansions. During crises, especially during severe ones, there is a retrenchment in both capital inflows by foreigners and capital outflows by domestic agents. Research has shown that a financial crisis is associated with the exit of investors; however, such crises are equally consistent with an inflow of foreign capital in the form of M&A, dubbed "fire-sale FDI" by (Aguiar and Gopinath 2005). After noting that foreign acquisitions increased by 90 percent in the East Asian crisis 1996-98, Aguiar and Gopinath provide an explanation for FDI's puzzling stability during crises. Firms plagued by liquidity problems are willing to sell their assets at lower prices to foreign investors—hence, the fire sale. India and China were the standout survivors of the financial crisis of 2008-09, invited to the Group of Twenty high table and expected to help steer the course for 21st century commerce. During the financial crisis, we observed large M&A activities flowing from India and China into those countries at the crisis epicenter—an outcome consistent with the theory.

⁹ Regional group definitions are from the World Bank: <http://data.worldbank.org/about/country-classifications/country-and-lending-groups>.

¹⁰ FDI to GDP ratios are frequently used to control for the size of the economies when doing comparisons of FDI.

Figure 4: Average Real GDP Growth and FDI Net Inflows

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

Regional South Asian Trends

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

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

FDI inflows, like portfolio capital inflows, move with the global business cycle; during the recent global crisis, FDI dropped in nearly all South Asian countries—some more than others. In relative terms, Pakistan was the most affected by the global crisis. It experienced an 83 percent drop in inward FDI flows as a share of GDP during in 2007-11 (Figure 6). Looking at absolute levels, both India and Pakistan had significant declines in FDI inflows after the crisis in 2008 (Table 1). India experienced a 44 percent slide in FDI between 2008 and 2010. Pakistan was affected even more. Annual FDI to the Pakistani economy fell by 63 percent during the same period and continued to fall in 2011. Foreign investors, particularly from Europe and the United States, suffered higher economic uncertainty, which may have led to the decrease in FDI. The fall was compounded by Pakistan’s weakening macroeconomic environment, combined with security issues and political uncertainty. Unlike Pakistan, India’s absolute inward FDI flows rebounded in 2011. The country’s FDI saw additional but more modest growth in 2012.¹¹

Most countries have seen a recovery in FDI flows after the global crisis. In 2009, Maldives’ FDI was 17 percent less than its 2008 level—but it has since more than recovered and is now higher than before

¹¹ As noted by India’s Planning Commission: “To achieve rapid growth, the economy will have to overcome constraints posed by limited energy supplies, increase in water scarcity, shortages in infrastructure, problems of land acquisition for industrial development and infrastructure, and the complex problem of managing the urban transition associated with rapid growth. Greater efforts also need to be made in agriculture, health and education to ensure inclusion of the most excluded and sometimes invisible parts of our population.”

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

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

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

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

Source: UNCTAD

Sectoral Composition of FDI in South Asia and Other Regions

FDI inflows into South Asia are concentrated in the service sector, while investments in manufacturing and agriculture and mining are much smaller (Figure 7).¹² A snapshot of the 2009 statistics shows that the service sector accounted for 72 percent of total inward FDI in South Asia (74 percent in India), making South Asia second only to the Europe and Central Asia region (Table 2). South Asia also ranks second among all developing regions in dollar value FDI flows into the service sector—around US\$1.9 trillion in 2009. However, South Asia’s service sector FDI inflows are not exceptionally high as a share of GDP. This reflects the region’s low overall FDI inflows—at 1.77 percent of GDP, the lowest among six regions and well below the developing country average of more than 3 percent (Table 3). As percent of GDP, FDI flows into the South Asian service sector ranked fourth among the six regions in the developing world. While South Asia, especially India, is one of the largest international hubs for the service industry, particularly Business Process Outsourcing (BPO), overall inward FDI flows as a share of GDP compared to the other regions remain modest.

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

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

Source: International Trade Centre and World Bank Staff Calculations

¹² The service sector includes: finance; wholesale and retail trade; business activities; transport, storage and communication; electricity, gas and water; hotels and restaurants; health and social services; education; construction; community, social and personal service activities; public administration and defense; and other services.

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

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

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

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

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

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

Source Countries for South Asia's FDI Inflows

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

Table 4: FDI into South Asia: Source Country Counts

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

Source: World Bank Staff estimates from UNCTAD statistics and fDimarkets

Despite the growing number of developing countries investing in South Asia, the developed countries still lead in the value of FDI—and this edge has risen since the 2008 global economic crisis. The value of developing country investments increased for much of the 2000s, hitting a peak of US\$603 billion in 2008, or about 39 percent of total inflows. However, the developing countries' share fell back to about 20 percent in 2010 (Figure 8). The global financial crisis' relatively harsher impact on developed economies spurred greater FDI flows into developing countries (hence increasing developed country shares of FDI and lowering developing country shares), including South Asia. Estimates for 2012 suggest that the largest declines in the developing nations' share of South Asia's estimated FDI inflows were from 2009 to 2010.

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

Source: UNCTAD statistics, fDiMarkets and World Bank staff calculations

From 2003 to 2011, almost 70 percent of South Asia's inward FDI was from developed countries, including 32 percent from the EU, 17 percent from the United States and 20 percent from other advanced economies. Among developing countries investing in South Asia, the largest shares of inflows arrived from the Middle East and North Africa (MENA) and the East Asia and Pacific Regions (EAP). South Asia itself accounted for almost 4 percent of FDI within the region (Figure 9). Looking at specific developing countries, the United Arab Emirates contributed 8.5 percent and China (including Hong Kong SAR, Macau, Taiwan, and mainland China) supplied 6 percent.

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

Source: Estimates from UNCTAD Statistics and fDiMarkets
Note: China includes Hong Kong SAR, China, Macau and Taiwan, China.

India contributes 70 percent of intra-regional South Asian FDI; however, total within-region FDI represents just 3.7 percent of all inward FDI in South Asia. The largest sources of inward FDI vary substantially across South Asian countries, but historical bilateral restrictions on FDI inflows from other South Asian countries have limited intra-regional flows. As shown in Table 5, FDI flows to India come primarily from developed economies, such as the EU, United States, Japan, and South Korea. In contrast, Pakistan's inflows are dominated by capital from the Middle East, while Bangladesh's and Sri Lanka's FDI comes from a handful of countries, including the EU, United States, India, and China. The Maldives has perhaps the most diverse spectrum of countries contributing FDI, including Thailand, India, United States, the EU, and China. Landlocked Bhutan and Nepal depend heavily on India for investment in their countries. Chinese companies have made large investments in extraction businesses, which account for a large portion of the FDI in Afghanistan. China has also been active in Nepal's renewable energy sector and in Sri Lanka's transportation sector, specifically building ports, but also in constructing hotels and investing in Sri Lanka's tourism sector.

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

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

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

Note: (*) China includes Hong Kong SAR, China, Macau and Taiwan, China; (**) Other includes all advanced economies other than US and European Union.

The South Asia region is becoming increasingly attractive to FDI, but FDI policies remain fairly restrictive. Overall, positive changes have taken place over the past few decades. The more advanced economies in South Asia have tended to move more quickly toward FDI liberalization and have more FDI-friendly policies. Nonetheless, investing across South Asia still faces significant barriers. The region has lagged in liberalizing policies that directly promote FDI, although it has pursued a number of trade-promoting agreements, which research shows also have a positive impact on FDI.¹³

Destination Countries for South Asia's FDI Outflows

South Asian firms, particularly in India, have increased their strategic outward investments. Improving ownership-specific advantages and increased financial capabilities have also played important roles in the strategic shift. Outward FDI flows from South Asia to the rest of the world took off in 2000, almost entirely because of India's more open stance toward outbound FDI. India's outward FDI more than doubled in 2001 to US\$1.4 billion and then jumped again to US\$14.2 billion in 2006. Although Indian firms had been investing overseas for decades, marked jumps in outward FDI occurred in the 1990s after market liberalization and again in early the 2000s after liberalization of foreign exchange transactions and gradual reductions in the limits on how much firms could invest abroad. In 2000, the Indian government implemented the Foreign Exchange Management Act (FEMA) to facilitate external trade and payments, providing a sound framework for cross-border investments.¹⁴ In addition, the Guidelines for Indian Joint Ventures and Wholly Owned Subsidiaries Abroad, as amended in October 1992, May 1999, and July 2002, provided for automatic approval of outward FDI proposals up to certain limits. The government raised the limit progressively from US\$2 million in 1992 to US\$100 million in July 2002. In January 2004, the limit was removed altogether, and Indian enterprises are now permitted to invest up to 100 percent of their net worth abroad on an automatic basis (Kumar, 2008). Like other large developing countries over the same period, India has seen an increase in outward FDI flows.

¹³ In 2006, the Agreement on South Asian Free Trade Area (SAFTA) was launched to reduce trade barriers within the region, although much remains to be implemented. In addition, three bilateral free-trade agreements have been signed: India-Bhutan, India-Sri Lanka, and Pakistan-Sri Lanka. Other trade agreements that incorporate South Asian countries include the Asia-Pacific Trade Agreement (India, Bangladesh, Sri Lanka, Philippines, Lao PDR, and Korea) as well as the Bay of Bengal Initiative for Multi-sectoral Technical and Economic Cooperation (BIMSTEC), which involves Bangladesh, Bhutan, India, Myanmar, Nepal, Sri Lanka, and Thailand, aims to achieve its own free trade area by 2017.

¹⁴ The Foreign Exchange Management Act (1999), or FEMA, was introduced to replace the Foreign Exchange Regulation Act (FERA). FEMA's main objective was to consolidate and amend the law relating to foreign exchange, with the objective of facilitating external trade and payments. It took effect June, 1, 2000. FEMA was introduced because the FERA didn't fit with post-liberalization policies. In a significant change, FEMA made all offenses regarding foreign exchange civil offenses, ending the criminal penalties dictated by FERA.

South Asia's outward FDI in 2005-10 totaled US\$85.2 billion (mostly from India), surpassing the Latin America and Caribbean region to become the fourth largest FDI investor among developing regions. The bountiful outward FDI shows South Asia's increasing competitiveness and integration with the global economy. Motivating South Asian companies to invest abroad are greater access to global markets, distribution networks, foreign technologies, and strategic assets like natural resources and brand names. A series of liberalization measures have paved the way for more cross-border investment by South Asian business. Today, South Asia is the fourth largest region for FDI outflows (Figure 10). After India, the largest flows of outward FDI from South Asia are from Bangladesh, Pakistan, and Sri Lanka. The other South Asian countries, however, show little outward investment (Table 6).

Figure 10: Average Regional and SAR Net Outward FDI Flows

Table 6: Outward Foreign Direct Investment Flows from South Asia, 2000-10 (FDI in million USD)

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

Source: UNCTAD statistics

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

- *Market access:* By undertaking overseas acquisitions, firms gain entry into the regulated markets of developed countries. The best example is the Indian pharmaceutical industry, where firms with

US FDA-approved facilities are looking for acquisitions in regulated foreign markets to ease the registration processes. The manufacturing activities will still be in India, taking advantage of lower costs.

- *Transfer of technology:* Manufacturing certain products requires technology that is not available to local companies. By acquiring companies abroad, they get access to advanced manufacturing technologies that further help reduce production costs.
- *New product mix:* Companies are also going abroad to broaden their product mixes or acquire products that will otherwise require huge investments and a long time to manufacture indigenously.
- *Presence in a location:* Certain industries spread around the globe through subsidiaries to cater to the tastes and preferences in a particular region. The acquisitions made by these companies are primarily for added value in their product profile.
- *Securing access to raw material:* The rapid growth of many large developing countries—in particular, China and India—is causing concerns about the availability of, and access to, key resources and inputs for continuing economic expansion. Investing abroad will help ensure availability and cost of inputs.

Determinants of FDI: An Empirical Analysis

So far we have detailed the general trends in FDI to the developing countries and South Asia in particular. In this section, we look at some of the key determinants of these trends to get insights into how developing countries in general may stimulate FDI, taking South Asia as one case study. Once the magnitudes and determinants of FDI are known, policy makers can direct their attention to enhancing the factors that are most critical to attracting FDI. Increased FDI can be a powerful complement to leveraging the competitive potential of South Asia, a region highly abundant in labor and natural resources.

What Might Be the Key Determinants of FDI?

Research on the determinants of FDI inflows is quite advanced. Several approaches have been taken, including looking at the patterns of FDI over time for a particular country, or a set of countries, as well as cross-country analysis, examining what determines FDI in countries based on certain economic, institutional, geographical, and policy characteristics. Because our main interest is identifying factors that may enhance FDI flows for developing countries, we model FDI growth as a share of GDP as a function

of key policy and economic fundamentals—those that have been found to be critical in influencing investors’ decision-making as well as those that may be particularly important in developing countries, such as energy availability, the level of trade barriers, and institutional capacity. We use cross-country data for 78 countries, both developing and developed, from 2000 to 2010.

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

Models of FDI growth are typically based on variants of the neoclassical growth model, with FDI being the variable of interest, rather than growth itself.¹⁵ Based on this literature, we model the growth rate of FDI as a function of the initial level of FDI, $\overline{FDI}_0$, along the initial state of other factors that determine growth, Y_0 , in addition to the factors that specifically are associated with attracting FDI, X : $\dot{FDI} = f(\overline{FDI}_0, Y_0, \dot{X})$. We linearize this equation as: $\dot{FDI} = \alpha + \beta_1 \overline{FDI}_0 + \beta_2 Y_0 + \beta_3 \dot{X} + \epsilon$. In this study our period of examination is 2000 to 2010 and we use the following basic cross-country reduced-form model:

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

where FDI represents inward FDI stock relative to GDP, NR represents the stock of natural resources per capita, the $\dot{X}_{t_1-t_n}$ denotes the growth rate and $\bar{X}_{t_1-t_n}$ denotes the annual average of the variable X over the period $t_1 - t_n$, F represents the vector of explanatory variables that includes proxies for human capital, corporate tax rates, energy availability, financial development, infrastructure, macroeconomic stability, trade barriers, investment policy openness, and control of corruption. The variables d_{oil} and d_{region} are dummies for oil exporter status and regional factors. In sum, the basic model explains the growth of inward FDI as a share of GDP between 2000 to 2010, based on the average initial stock of FDI

¹⁵ For example, Borensztein et al. (1998), Baumol (1986), Barro and Sala-i-Martin (1992, 2003).

as a share of GDP over the period 2000-05 and the stock of natural resources per capita at the beginning in 2000, the change variables, $\dot{F}$, in the initial years examined (2000-05), and controls for regional and oil exporter fixed effects.

The specification of variables is based on the previous literature, with some notable innovations.¹⁶

Unlike prior formulations, this analysis considers the long-run *growth* of FDI/GDP (rather than the FDI/GDP levels or short-run movements) and controls for the initial FDI/GDP stock to account for pre-existing conditions that may have determined prior levels of FDI/GDP.¹⁷ This formulation was used for several reasons, including: 1) it provides a method for determining whether FDI/GDP is converging or diverging between countries, based on the coefficient on the initial stock of FDI/GDP, 2) reduces the likelihood of endogeneity (although does not eliminate it) and limits the noise of short-term fluctuations because the explanatory variables are average growth from the first part of the period, rather than simultaneous with the dependent variable and 3) allows some means for looking at the dynamics of FDI without use of a panel data set, which increases the number of observations available and allows us to include most of the South Asian region in the data.

A high initial FDI/GDP level may be a conduit for high future FDI/GDP growth, signifying strong institutional qualities, agglomeration effects, and other factors, or it may point to lower future FDI/GDP growth due to diminishing returns on FDI investment in a market that may already be well developed. The past decade suggests the latter effect may dominate because the stock of FDI remains highest in developed countries, but recent growth has been highly concentrated in developing countries. With the highest FDI growth taking place in those countries with relatively small initial levels of FDI, a trend toward convergence in the relative FDI stock may emerge. This is consistent with declining returns to FDI investment as the stock of FDI increases. Unlike other models that attempt to explain the determinants of FDI, our empirical exercise actually sets quite a high hurdle for finding significant impacts of the explanatory variables. Not only is it restricted to explaining the FDI growth relative to GDP, but it also holds constant the initial level of FDI relative to GDP. Consequently, changes in the factors that may explain FDI/GDP changes will only be important if they add explanatory power above the historical FDI/GDP factors.

¹⁶ This specification follows similar application of FDI can be found in Walsh and Yu (2010), Asiedu (2002), Noorbakhsh, Paloni and Youssef (2001), Mohamed and Sidiropoulos (2010) and Lall, Norman and Featherstone (2003).

¹⁷ We specifically examine long-run trends in FDI inflows to GDP to abstract from short-term cyclical factors.

What Are the Components of the Analysis?

The analysis uses cross-country data from 78 developing and developed countries between 2000 and 2010. All variables, except initial FDI/GDP level and natural resources per capita, are average annual growth rates for 2000-05 and 2000-10 and are calculated as $\dot{X} = (X_T/X_1)^{(1/T)} - 1$, where X_T is the observation of the last year, i.e. $T = 11$ for time period 2000-10 and $T = 6$ for time period 2000-05, X_1 is the observation for the first year (2000). The dependent variable is the growth of inward FDI/GDP from 2000-10, and the independent variables are all growth rates over the first half of the period—with two exceptions. The initial level of inward FDI/GDP is the arithmetic average of the variable over the first half of the period and natural resources per capita is measured in 2000 because it does not change much over the period under study and is a stock variable. A brief description of each of the variables and their expected impact on the growth of inward FDI follows:¹⁸

Inward FDI Stock as a Share of GDP: As is discussed above, *growth* of inward FDI stock as a share of GDP is the dependent variable—ultimately, the variable of interest. However, its level at the beginning of the growth period is an explanatory variable and plays an important role in our analysis. It proxies for all the initial conditions the regressors might have on FDI growth, whether it is a low tariff rate at the start of the period, energy availability, or other factors. It may have a positive or negative sign depending on whether the agglomeration effect (greater FDI attracts more FDI) outweighs the convergence effect (diminishing returns to additional FDI).¹⁹ Data on the *inward FDI stock* are from UNCTAD Statistics, Catalogue of Foreign Direct Investment.

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

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

¹⁸ The summary statistics table is provided in Annex.

¹⁹ For example, see (Wheeler and Mody 1992), (Barrell and Pain 1999), (Campos and Kinoshita 2003), and (Walsh and Yu 2010).

Human Capital: Higher levels of human capital may have a positive or negative impact on attracting FDI inflows, depending on whether FDI is primarily directed to technology-based industries that depend on skilled labor (Lucas 1990; Zhang and Markusen 1999) or labor-intensive industries attracted to a low-wage labor force (Agarwal 1980).²⁰ In this study, we use the *educational attainment data set* provided by Barro and Lee on their website.²¹

Quality of Institutions: The role institutions play in all globalization-related issues, including financial globalization, has gained increasing attention in recent decades.²² Better institutions decrease all types of costs—such as financial, time, and effort costs—related to starting, continuing and even ending a business. They also help create a more business-friendly economic environment by increasing the transparency of rules and regulations and decreasing the information asymmetry in investment-related activities. In this study we use measures of *Control of Corruption* and *Political Stability* data available in the World Bank’s Worldwide Governance Indicators (WGI).

Investment Policy Openness: The more open the investment regime, the greater the expected FDI flows. Most countries have restrictions on investment, and, as noted above, these barriers are particularly in South Asia. Some nations impose different rules for foreign and domestic investment; some restrict access to foreign exchange; some impose limits on payments, transfers, and capital transactions; some close certain industries to foreign investment. The proxy for this variable comes from the Heritage Foundation’s *Investment Freedom Index* and takes the value of 100 for no restrictions and subtracts points for each restriction found in a country’s investment regime.

Infrastructure: The availability and quality of infrastructure is a key determinant of FDI inflows.²³ Better infrastructure facilitates investment, decreases production costs, improves service provision, and increases investment returns. This study relies on the most frequently used data on infrastructure—the *ICT infrastructure* data, which can be found in the World Bank’s WDI. Other data utilized for robustness, although not as complete, *quality of logistics and ports* and *roads per capita* are used for robustness. They are available at the same source.

Trade Openness: Free trade should be an important factor for attracting FDI, particularly in export-oriented businesses. In addition to allowing the FDI-related products to be easily exported, more open trade lowers the costs of imported inputs. On the other hand, high tariff barriers may also attract FDI by

²⁰ For example, see (Root and Ahmed 1979), (Schneider and Frey 1985), (Narula 1996), and (Noorbakhsh, Paloni and Youssef 2001).

²¹ <http://www.barrolee.com/>

²² For example, see (Wheeler and Mody 1992), (Root and Ahmed 1979), (Agarwal 1980), (Wei 2000), (Asiedu 2002), (Dutta and Roy 2008), and (Solomon and Ruiz 2012).

²³ For example, see (Addison and Heshmati 2003), (Asiedu 2002), and (Blonigen and Piger 2011).

providing entry into a protected domestic market with prices higher than what they would be in competitive markets. *Applied tariff rates* are the proxy for trade openness. The data come from UNCTAD Statistics, Catalogue of International Trade under the “Market Access” category. Alternative measures of trade policies are also used, such as the ratio of imports and exports to GDP and the Overall Trade Restrictiveness Index, available from the World Bank’s WDI.²⁴

Energy Availability: Availability of energy is a key determinant for any kind of investment in the production sector, and its scarcity may be a big deterrent of FDI in developing countries (UNCTAD 1998).^{25,26} In this study, we measure energy efficiency by *electric power transmission and distribution losses (percent of output)*, available from the World Bank’s WDI.

Natural Resources: Natural resource availability has often been studied as a determinant of FDI.²⁷ It captures both the incentives for investments to exploit countries’ natural resources and the availability of productive inputs. We measure natural resources on a per capita basis to control for population size. The data include oil and natural gas as well as other resources. However, the marginal impact of this variable is primarily non-oil and natural gas resources because we include a dummy variable to capture the particular structure of oil-exporting economies. The variable is measured in thousands of US dollars per capita and includes the estimated discounted present value of *Crops, Pasture Land, Timber, Non-Timber Forest, Protected Areas, Oil, Natural Gas, Coal, and Minerals resources*. The estimates, produced by the World Bank staff, are available in *The Changing Wealth of Nations* catalogue.

Financial Development: On one hand, financially developed economies ensure the availability of required capital for production and may act as an FDI deterrent. On the other hand, financial deepening can also decrease transaction costs of investment and facilitate all sorts of financing activities, thus playing a key role in attracting FDI (Al Nasser and Gomez 2009). As in other studies, financial development is measured by the private credit to GDP ratio, available from the World Bank’s WDI.²⁸

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

²⁴ Please refer to (Gastanaga, Nugent and Pashamova 1998) to learn about different measures of openness.

²⁵ For example, see (Noorbakhsh, Paloni and Youssef 2001), and (Wilhelms 1998).

²⁶ Energy-investment relationship is detailed in a global corporate survey by PricewaterhouseCoopers 2012.

²⁷ For example, see (UNCTAD 1993, 1998), (McKern 1996), (Asiedu 2002), (Mohamed and Sidiropoulos 2010), and (Anyanwu 2012).

²⁸ For example, see (Demirgüç-Kunt and Beck 2009) and (Beck, Demirgüç-Kunt and Levine 2000).

Empirical Findings

Table 7 below shows the regression results, presented for developing countries only (first four columns) and for the world as a whole, including both developing and developed countries (last four columns). Developing countries are those with upper middle income status or below.²⁹

Columns 1 and 5 present the base model results for the developing countries and the world samples and the remaining columns show alternative specifications. For the most part, the variables have the expected signs. The initial FDI/GDP share is negative, suggesting conditional convergence. FDI as a share of GDP is growing faster in countries that have lower FDI stocks, but this is significant only in the world sample (column 5). This variable's higher significance in the world sample is probably due to greater FDI flows going from developed to developing countries over the sample period; hence, this factor has more variance in the world sample. The size of the coefficient suggests that countries with low FDI/GDP are conditionally catching up to countries with higher FDI/GDP at a rate of about 0.06 percentage points per year.³⁰

²⁹ World Development Indicators (<http://data.worldbank.org/data-catalog/world-development-indicators>).

³⁰ The rate of convergence is calculated as $\lambda = -\ln(1 + \hat{\beta})/t$, where t is 1 (since growth is annualized, the period over which growth is calculated is 1) and $\hat{\beta}$ is the estimated coefficient on the level of FDI/GDP in the starting period.

Table 7: Determinates of FDI

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

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

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

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

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

In both the developing country and world samples, efficiency of energy supply and macroeconomic stability do not appear to have a statistically significant impact on the growth of FDI/GDP. The lack of significance on these variables may either be because they are not good proxies for the presumed economic relationships (a country may have a plentiful supply of energy, but nonetheless be subject to large distribution and power losses, for example) or, they may simply not be consistently good indicators for determining the growth of FDI/GDP. Other factors that were believed *a priori* to be potentially important to determining FDI/GDP growth, such as wage rates, infrastructure, and financial market development, proved to be less robust than expected, with high standard errors and weak significance.

Overall, the empirical results explain about 60 percent to 70 percent of the variation in FDI/GDP growth for the developing countries and the world sample, as indicated by the adjusted R-square.³¹ The summary statistics of the variables are presented in the Annex.

How Does South Asia Rank among Other Developing Countries?

The series of graphs in Figure 11 compares South Asia and other developing regions on the explanatory variables used in the regression analysis. India and the rest of South Asia stand out generally as having a weak environment for attracting FDI. It had the lowest initial level of inward FDI/GDP. It had the lowest reduction corporate tax rates as a share of profits (and actual increases in South Asia excluding India). It has had the largest decline in investment policy openness, the lowest level of natural resources per capita, and largest deterioration in political stability (particularly for South Asia excluding India).

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

³¹ The equations were estimated utilizing the Huber-White sandwich estimators, with account for a collection of potential concerns over the violation of the standard assumptions of OLS estimators, such as normality and possible heteroscedasticity. Other potential problems like model specification and nonlinearity of the parameters were tested using the Ramsey Reset test, but were not found to be statistically important issues.

Figure 11: Determinants of FDI/GDP Growth (Regional Groupings), 2000-10

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

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

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

Compared to other developing countries, South Asia's is quite modest on factors that contribute to FDI/GDP growth (Figure 12). While all developing countries have slid in investment policy openness and control of corruption, South Asia, as a whole, has seen the largest declines by far, contributing to its slower FDI/GDP growth. While developing countries as a whole have reduced corporate taxes, South Asia stands out as a laggard primarily due to increases in Sri Lanka's tax rate.³² Trade liberalization has been a positive contributor to South Asia's FDI/GDP growth, but the region has done less than other developing countries. On a positive note, South Asia's low initial level of FDI stock suggests greater potential for future FDI growth.

Figure 12: Contribution of SAR Economic Fundamentals to FDI/GDP Growth
(Dependent Variable: Inward FDI Stock (% GDP) Annual Growth, 2000-10)

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

Figure 13 splits South Asia into its constituent countries to show the diverse regional experience, but also commonalities across the region. India, which accounts for some 85 percent of regional FDI inflows, is unique in its strong improvements to investment policy and trade liberalization, which have played a positive role in enhancing growth in FDI/GDP. Its other characteristics that influence foreign direct investment, such as control of corruption and corporate tax changes, have been quite similar to the

³² It should be noted that while moving to zero corporate tax rates may promote higher growth in FDI/GDP, it may not be conducive to fiscal revenue objectives, nor be the least distortionary way of raising revenues. This paper does not address these issues.

rest of South Asia. For Pakistan, reductions in corporate tax rates have been a large positive factor in enhancing FDI/GDP growth compared to other developing countries and the rest of South Asia, while control of corruption and improvements in investment policy growth have been relatively large detractors.

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

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

The estimated model suggests potential for improving FDI inflows to South Asia via policy enhancements. Table 8 shows actual and predicted FDIs from 2005 to 2015. The actual annual growth of FDI/GDP fell for most countries in South Asia in the second half of the 2000s, on average decreasing from 6.5 percent to 1.5 percent with the exception of India and Pakistan. India's FDI/GDP growth increased from 6.7 percent during 2000-05 to 14.9 percent over 2005-10, while Pakistan's rate increased from -0.6 percent to 3.3 during the same period.

Using fitted regression model with actual data from 2005-2010, we can predict what the average annual rate of growth will be up to 2015. Overall, the annual average growth of FDI/GDP is expected to increase from 1.5 percent in the second half of the 2000s to 3.9 percent up to 2015 (column 3, Table 8). This reflects a large jump in FDI/GDP growth Bangladesh, and more moderate increases in Bhutan, Nepal, and Pakistan, but slower growth in the other South Asian countries.

An alternative forecast is provided in column 4, which makes a hypothetical forecast that assumes that South Asian countries are to make progress on policies that attract FDI/GDP (up to the developing country average) and maintain their other policies that are already above average. Under this scenario, annual FDI/GDP growth would increase to 6.6 percent through 2015, which is 2.7 percentage points higher annually than if policies were maintained. Overall, the results suggest South Asia has the potential, through policy changes, to take important steps to becoming a much greater magnet for foreign investment.

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

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

Table 8: Model Predictions
(Inward FDI stock (% GDP) annual avg. growth)

Country	(1) Actual FDI/GDP Growth 2000-2005	(2) Actual FDI/GDP Growth 2005-2010	(3) Predicted FDI/GDP Growth, to 2015	(4) Predicted FDI/GDP Growth, to 2015, Improving to Developing Country Average*
South Asia Avg.	6.5%	1.5%	3.9%	6.6%
Bangladesh	4.3%	-0.1%	12.9%	14.0%
Bhutan	17.4%	0.03%	4.5%	8.0%
India	6.7%	14.9%	3.2%	6.1%
Maldives	13.7%	8.9%	3.2%	7.9%
Nepal	3.5%	0.4%	1.7%	5.7%
Pakistan	-0.6%	3.3%	5.9%	7.6%
Sri Lanka	0.8%	0.1%	-4.0%	5.2%

* Improved predicted FDI inflow, 2005-2015, is based on the value of the explanatory variables adjusted to developing countries average whenever they are less than the developing countries average.

Conclusions

Globally, inward FDI flows have followed a hump-shaped pattern over the past decade, with strong growth before the global crisis and a sharp drop as many economies struggled during 2008-2009. FDI inflows to developed economies fell significantly in the midst of the crisis, and have yet to fully recover; by contrast, FDI flows to developing economies have begun to recover more rapidly than many forecasters would have predicted. Recent decades have seen a gradual shift of the center of gravity for FDI inflows from developed economies to developing ones. Currently, more than half of the FDI goes to developing countries. Strong growth in the developing countries, overall improvement in their business environments, and more open FDI policies have played a large role in the paradigm shift. Many emerging economies have been actively courting FDI from both advanced and other developing countries. They're doing so to take advantage of supply-chain linkages, technology transfers, and natural resource opportunities. India has been a notable player in this process.

While South Asia has seen FDI increases in the past decade, as have other regions, the region's challenges put in sharp contrast policies that can impact FDI for all developing countries. Weak fundamentals have prevented more FDI flows into South Asia. The composition of FDI is heavily focused on the service industry, which may reflect the region's comparative advantage in this sector, but also may indicate that FDI into other sectors, such as manufacturing, is low due to insufficient infrastructure and cumbersome regulations that discourage FDI inflows to these industries more than into services.

The empirical analysis presented in this study offers a powerful set of factors as key contributors to FDI growth—control of corruption, non-punitive corporate taxes, reduced trade protection, and greater investment openness. Developing countries have several good options for improving FDI flows and doing so could provide a strong foundation for continued growth. For South Asia, progress has been

made on the policy front over the past decade, but policy makers need to remain vigilant and keep the reform momentum going forward rather than sliding backwards, particularly in the current context of South Asia's economic slowdown. Regional growth has slowed from 9.3 percent in 2010 to 5.4 percent in 2012, and some local businesses are advocating quick short-term solutions through protected markets. Concerns have recently been raised by multinational corporations that new policies to protect domestic business are deteriorating the attractiveness of investing in the region, and thus may hurt long-term growth prospects. Initiatives to promote domestic interests, while at first appearing to help strengthen the domestic economy may, in the end, do just the opposite. While foreign direct investment is not the only building block of a strong and growing domestic economy, it complements other components and is oftentimes a bellwether for future growth prospects.

Annex: Summary Statistics and Correlation Matrix

Summary Statistics, 2000-2005 world sample

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

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

Correlation Matrix

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

All variables belong to 2000-2010 time period.

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