Indo-EU FTA: Opportunities for Intra-Regional Investments in South Asia

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Indo-EU FTA

- Loss of preferences to LDCs, mainly in Textile and clothing sector.

- Access to Indian Market

- Access to EU Market

S.No	**HSCode**	**Number of Tariff Lines**	**South Asia Exports to India (USD Mn)**
1	25	3	56
2	**27**	**2**	**74**
3	28	2	38
4	31	1	51
5	32	1	10
6	33	1	15
7	34	1	7
8	38	2	18
9	39	2	52
10	40	2	21
11	41	2	13
12	44	1	6
13	47	1	13
14	52	3	23

	HSCode	Number of Tariff Lines	South Asia Exports to India (USD Mn)
15	53	3	60
16	54	2	22
17	55	3	32
18	56	2	17
19	60	1	7
20	63	1	26
21	68	1	16
22	**72**	**8**	**138**
23	73	2	40
24	**74**	**5**	**112**
25	76	1	13
26	78	1	34
27	84	1	6
28	85	3	45
TOTAL		58	**965**

HS Codes	South Asia(Ex India) Exports to EU
61	**3,681,967**
62	**1,990,594**
52	**535,567**
3	370,755
63	286,669
90	107,279
55	92,959
41	91,802
95	86,184
64	80,473
22	69,327
39	59,882
87	59,377
53	54,890
42	50,779
7	38,727

HS Codes	South Asia(Ex India) Exports to EU
30	32,595
54	29,410
58	24,677
69	23,668
84	22,052
82	18,999
56	16,413
88	15,744
49	15,161
6	14,734
16	13,235
17	12,288
8	10,191
5	9,248
24	8,487
13	7,872
73	6,291
Total	**8,062,528**

“Regional Response”
to Bilateral FTAs of India

Trade and Inward FDI: Theory

- FTAs lead to higher FDI-The location specific and firm-specific advantages change.
- MNCs restructure their production bases to take advantage of reduced trade costs while exploiting scale economies and agglomeration advantages.
- Better access to a larger market may attract FDI (from within the region as well as from outside) to countries that have a strong locational advantage.
- Vertical FDI encouraged in place of horizontal FDI (Knowledge-Capital model was empirically tested by Carr et al. (2001)

Trade and FDI Linkages
Empirical Evidence

- Globerman and Shapiro (1999) find that Canada-U.S. Free Trade Agreement (CUFTA) and North American Free Trade Agreement (NAFTA) increased both inward and outward FDI.

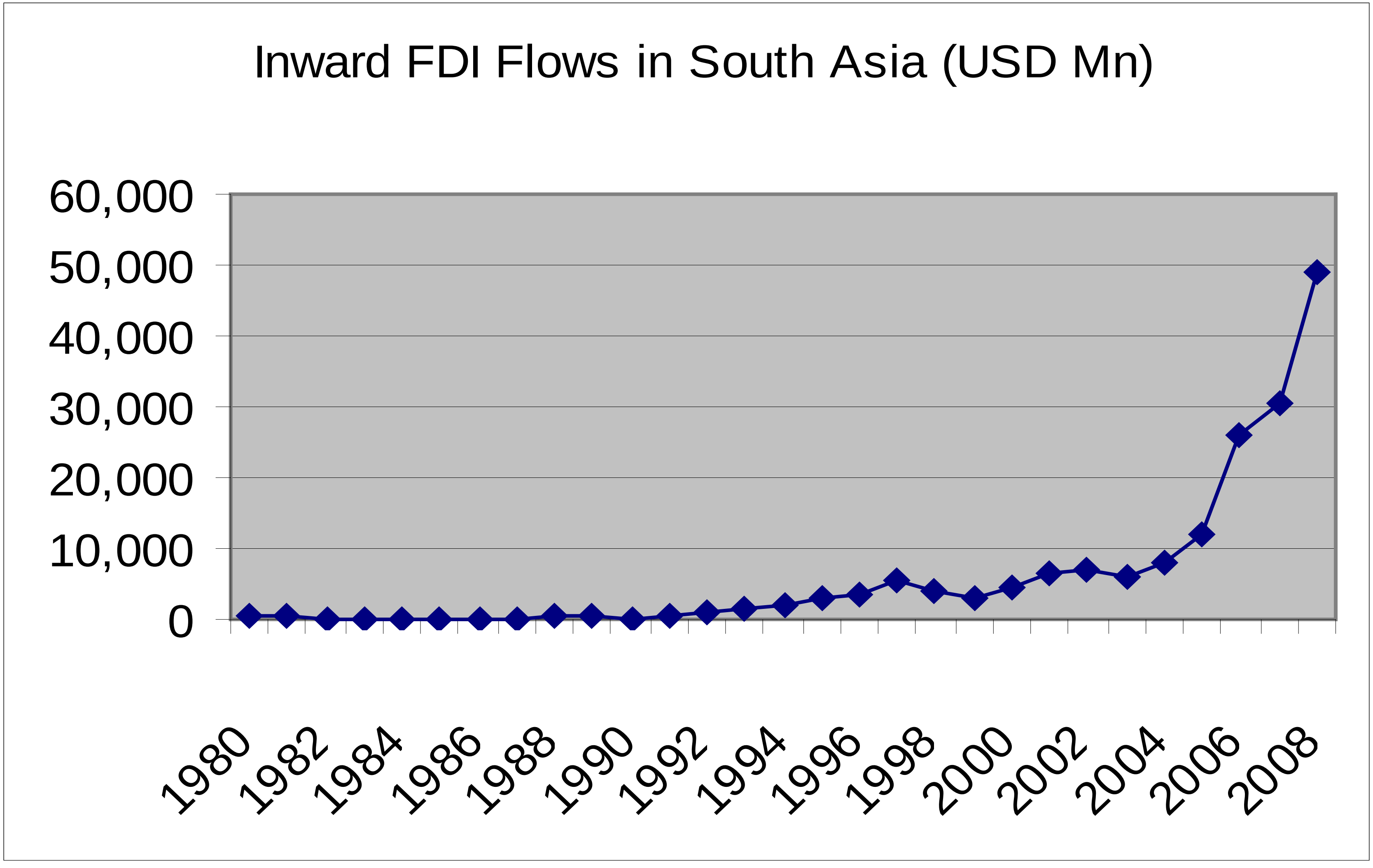
- In the context of Korea-U.S. FTA, Kang and Park found that FTA increased FDI by 14-35% from member countries and by 28-35% from non-member countries.

- Baltagi et al. (2005) conducted a study on bilateral outward FDI stocks into Europe over 1989-2001 and found that an RTA increases FDI up to 78% among European countries.

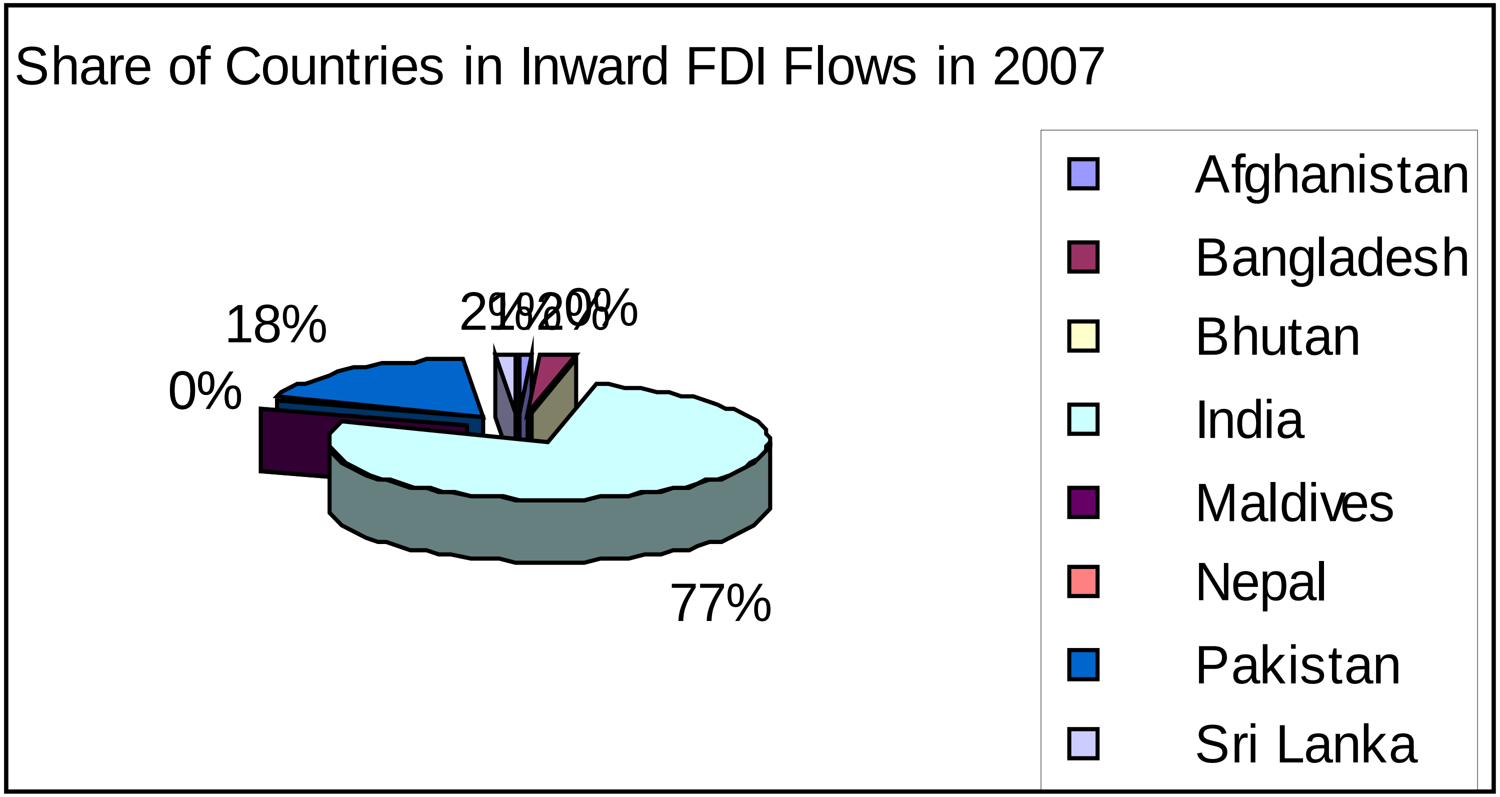
- Banga (2004) shows that regional trading agreements like ASEAN and APEC can influence FDI inflows into the region as the risks associated with investments decline with greater regional integration.

FDI Inflows into South Asia

- FDI inflows in 2008 to South Asia amounted to $**49** billion, respectively (UNCTAD)
- For South Asia, FDI has increased by 40% as compared to 2007, while declined by 14% in South East Asia.
- In 2009, FDI inflows do not seem to have declined (till March 2009); mainly because of India.
- But FDI rose in 2008 as compared to 2007 in – Pakistan, Bangladesh and Sri Lanka.



Inward FDI Flows in South Asia (USD Mn)
60,000
50,000
40,000
30,000
20,000
10,000
0
1980
1982
1984
1986
1988
1990
1992
1994
1996
1998
2000
2002
2004
2006
2008


Share of Countries in Inward FDI Flows in 2007
18%
0%
77%
Afghanistan
Bangladesh
Bhutan
India
Maldives
Nepal
Pakistan
Sri Lanka

FDI Inflow 2006: Distribution by Sectors (Million US$).

Sources	Sectors				
	Agri & Food	Industry	Services	Misc	Total
South Asia Total	0.15	**1.43**	0.52	0	2.1
India	0.15	0.84			0.99
Pakistan		0.59			0.59
Sri Lanka			0.52		0.52
Nepal					
Bhutan					
Maldives					
Global Total	5.32	15.76	469.1	0.1	490.27
Share of South Asia in Global Total	2.70%	9.10%	0.10%	0%	0.40%

Outward FDI from India in South Asia (USD Mn)

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

How to boost Intra and Extra Regional FDI?

Regional Integration: and Investment Potential

- Investment potential in South Asian countries:
  - resource availability,
  - access to market,
  - strategic locational advantage
  - and technological upgradation.

SAFTA –Can be Important Step Towards Encouraging FDI

- With FTA the location advantages of the region will change.
- Forms can restructure their production bases to take advantage of reduced trade costs while exploiting scale economies.
- Better access to a larger market may attract FDI (from within the region as well as from outside) to countries have a strong locational advantage.
- Vertical FDI will be encouraged in place of horizontal FDI

“Flying Geese” and Potential for Supply Chains

- Can South Asia repeat the “Flying Geese” experience of East and South East Asia?
- Can EU be catalyst for forming supply chains in South Asia?
- Large potential exists- Vertical FDI and supply chains in sectors like:
- A) Textiles and Textile Products
- B) Auto and Auto Components
- C) Services sectors-IT and ITES (BPO Off-shoring)
- UNCTAD-India- Ongoing Study

- With respect to the South Asia, very few studies have estimated the impact of intra-regional trade on inward and intra-regional FDI. One of the reasons for this is lack of bilateral data on FDI over time.

- UNCTAD-India (2008) estimated the impact of intra-regional trade on inward FDI into member countries of SAFTA and domestic investments in the member countries- **seven member countries of SAFTA for the period 1980-2006**

- The fact that SAFTA is still in its infancy makes it difficult to estimate its impact on FDI into the region. Alternatively, the impact of tariffs of each member country vis-à-vis other SAARC countries on inward FDI into the country has been estimated,

UNCTAD-India Study: Determinants of FDI

- Economic Fundamentals- market variable (i.e., potential market size), cost variables (i.e., cost of labour in terms of efficiency wages) and human capital (i.e., literacy rate) in the economy.
- Higher trade in the region will attract higher extra-regional FDI into the region. To capture the impact of SAFTA we use weighted average of MFN tariffs of each member country of SFATA with respect to other member countries as a group
- Number of bilateral investment treaties (BITs) signed by a country.

Trade-Determinant of Vertical FDI

- To test whether FDI into the region may follow product fragmentation or not we estimate exports of each member country of SAFTA to other member countries as a group and imports of each member country of SAFTA from other member countries as a group.
- If higher share of SAARC in trade of a country attracts higher FDI it indicates that FDI may seek economies of scale and choose to locate in the country with higher access to the SAARC market.
- Imports of intermediate goods in a country from other member countries on inward FDI into the country is included. Positive impact will indicate that a country which has higher share of imports from SAARC in its total imports will attract vertically-integrated FDI which may choose it as its destination

	Bilateral Investment Treaties (BITs):2006		Double Tax Avoidance Treaty (DTT):2006	
	Total	Within South Asia	Total	Within South Asia
Bangladesh	4		25	India, Sri Lanka, Pakistan
Bhutan	0			
India	60	Sri Lanka	67	Sri Lanka, Nepal, Bangladesh, Pakistan (Limited)
Maldives	0			
Nepal	4		6	India, Sri Lanka, Pakistan
Pakistan	46	Sri Lanka	46	India (Limited), Sri Lanka, Bangladesh, Nepal
Sri Lanka	25	India, Pakistan	34	India, Pakistan Nepal

Source: UNCTAD 2008

Empirical Results

- The results show that the economic fundamentals of a SAFTA member country have a significant impact on inward FDI.
- Domestic market size, low cost of labour and availability of skills attract FDI from outside the region.
- **Higher trade openness attracts higher FDI.**
- Tariffs with respect to other SAFTA member countries has a negative impact which indicates that lowering of tariffs following SAFTA will attract FDI from outside the region into the region. The coefficient indicates that the impact will be significant, i.e., <u>30% of the rise in inward FDI may be because of lowering of inter-regional tariffs.</u>
- The imports of intermediate goods in the host country have a significant impact on inward FDI. <u>SAFTA may therefore encourage vertically-integrated FDI.</u>
- <u>Apart from the trade-related variables the results show that Bilateral investment treaties (BITs) signed by the host country has a significant impact on inward FDI flows.</u>

Major Challenges

- Non Tariff Barriers
- Trade Facilitation
- Investment Climate
- Trade Liberalisation in Services
- Political Stability in the region

Investment Climate-Current Status

- There are vast differences in terms of the technological sophistication of countries in South Asia.
- The Global Competitiveness Report 2007-8 reports that India leads the group and is ranked 48th followed by Sri Lanka (70), Pakistan (92), Bangladesh (107), and Nepal (114).
- In terms of the “basic requirement factors” (macro economic stability, institutions, infrastructure) the countries are ranked close. In “efficiency enhancing factors” the ranks differ significantly.
- In the third category “technological readiness and innovative capabilities”, the gaps seem to be huge.
- These suggest possibility of gains in technology transfers and efficiency with higher intra-regional FDI.

Challenges in Liberalisation of Services

- Provision of many services like transports, infrastructure, etc has been under state monopolies for a long time in South Asian countries and only in the last decade or so privatization of these services has taken place.
- This makes provision of services by foreign services providers an extremely sensitive issue as it entails the risk of eroding not so competitive domestic investments in these services.
- Not being able to regulate the quality and prices of the services provided.
- **However, efficient services required to increase the efficiency of manufacturing sector**
- Domestic regulations and Over regulation

Future Directions

- Change Mindsets and Consider FTAs as an opportunity as these **provide further rationale for regional integration**
- Boost intra-regional trade for increased intra-regional FDI: Need to give fresh push for ‘full implementation of SAFTA’-**if possible with zero negative lists**.
- For the region to emerge stronger in future it is important to identify areas and sectors that may become future growth poles, e.g., different forms of sustainable agriculture (including organic) and resource-efficient products, like solar energy using products, etc. Can FDI help?
- Encouraging BITs within the region and inter-regional Investment Agreements

“Immediate Baby Steps”

- Research needed to identify possible sectors and potential supply chains at disaggregated level.

- Industry consultations-to increase awareness of business possibilities

Future Goals

- Absence of a harmonized trade regime which include different kinds of standardization and certification processes, different custom rules and regulations, different tax laws and regulations and duty structures.

- Outward FDI flow from India and Pakistan is controlled (restricted by means of minimum holding periods, classes of investors etc) and partly restricted (prohibited without permission) in countries like Sri Lanka and Bangladesh. India is making changes in its policies.

- **Under a common investment framework, investment potentials of all South Asian countries could be developed in a coordinated manner.**

Can Higher Investments and Trade in the region lead to Political Peace?

- Thank You