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Foreign Direct Investment (FDI) and Economic Reforms: The South Asian Perspective

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Introduction

The purpose of this paper is to discuss some of the trends and patterns of foreign direct investment (FDI) inflow in four South Asian countries namely Bangladesh, India, Pakistan and Sri Lanka. The impact of major economic liberalization reforms on inward FDI will also be analyzed at the end. In this paper, panel data estimation is conducted in the empirical analysis of impact of economic reforms on FDI in South Asia (SA).

The paper is organized as it follows: In the first part, basic trends and patterns of FDI inflow for four major economies in SA will be discussed. In the second section, economic liberalization reforms and their impact on inward FDI of the above South Asian nations will be examined using panel data estimation. The final section concludes the paper.

Inward FDI Flow of Bangladesh

After independence, Bangladesh got the first FDI inflow in 1973; however, during the whole 1970s FDI inflow in the newly established country was very low. Starting from the early 1980s, Bangladesh adopted several policy measures to attract more foreign investment. During that time FDI inflow to Bangladesh was very much expected to underwrite its savings-investment gap and to redress its export-import imbalance. As a result of various reforms, foreign investment has increased to some extent but not its satisfactory level. According to data provided by the Bangladesh Bank, the nation has received around US$ 12.06 billion of foreign direct investment during the period 1996-97 to 2012-13. Over this 17 years, with the highest annual inflow of US$ 1730.63 million recorded in 2012-13 fiscal year and the lowest amount of US$ 284 million in 2003-04. The next table shows time series FDI inflow data in Bangladesh since 1996-97 fiscal years.

Table 1: FDI Inflow in Bangladesh from 1996-97 to 2012-13

(In US$ million)

Period	FDI inflow					
	Equity Capital	Reinvested Earnings	Intra-company Loans	EPZ	Non-EPZ	Total Inflows
1996-97	136.71	151.27	78.87	46.12	320.23	366.85
1997-98	349.02	181.31	72.97	123.37	479.93	603.30
1998-99	195.54	120.71	77.85	45.72	348.38	394.10
1999-2000	152.98	80.71	149.53	181.91	201.31	383.22
2000-01	372.27	81.00	110.66	66.06	497.87	563.93
2001-02	230.11	84.66	86.16	59.28	341.65	400.93
2002-03	163.98	164.97	50.23	86.72	292.47	379.18
2003-04	111.23	161.38	11.55	38.92	245.23	284.16
2004-05	361.14	297.11	145.53	90.23	713.55	803.78
2005-06	447.22	198.64	98.75	74.51	670.10	744.61
2006-07	464.50	281.00	47.24	110.78	681.96	792.74
2007-08	545.69	197.71	25.29	88.14	680.55	768.69
2008-09	535.42	336.61	88.56	129.34	831.25	960.59
2009-10	515.14	331.10	66.78	151.11	761.91	913.02
2010-11	249.95	445.19	83.90	181.45	597.59	779.04
2011-12	454.10	542.35	198.43	185.26	1009.62	1194.88
2012-13	761.03	645.64	323.96	369.75	1360.88	1730.63

Sources: Foreign Direct Investment (FDI) in Bangladesh Survey Report January-June, 2013 by the Statistics Department of Bangladesh Bank

Bangladesh receives FDI from many developed and developing countries. Until today, 53 nations around the globe have invested in Bangladesh. The major investing countries are UK, USA, Japan, Hong Kong, and South Korea. For an instance, in FY 2000-01 FDI of US$ 20.56 million came from U.S.A., US$ 26.89 million from Hong Kong, US$ 40.37 million from South Korea, US$ 8.80 million from India and US$ 17.18 million from Japan. According to the latest data, inflows of FDI in 2013 were US$ 337.97 million from Malaysia, US$ 103.6 million from Singapore, US$ 159.49 million from U.K, US$ 86.34 million from Hong Kong, US$ 71.07 million from U.S.A., US$ 124.94 million from South Korea, US$ 99.04 million from Japan and US$ 84.96 million from Netherlands (Bangladesh Bank, 2013).

FDI inflows into Bangladesh have been concentrated in two principal sectors: services and industry. In 2013, the shares of these two sectors were US$ 887.32 million and US$ 806.55 million respectively. Among the services sector, the Transport and Telecommunications sub-sector was accounted for US$ 527.09 million while the Trade and Commerce sub-sector earned US$ 295.05 million. The rest went to other services category. In the case of industry sector, the major share of US$ 712.88 million was invested in the manufacturing sub-sector and a tiny part went to Power, Gas and Petroleum sub-sector. Recently the textile and Ready Made Garment (RMG) have emerged as the major manufacturing sector for Bangladesh and most of the manufacturing FDI actually came to this sector in 2013. On the other hand, agriculture and fishing received only a marginal share (US$ 29.72 million) of the total FDI flow to the country.

The Textiles & Wearing industry is one of the largest recipients of FDI in Bangladesh. Although the sector has better potential for foreign investment and its current share is higher than those of many other sectors in the country, the amount of FDI stock or share of FDI inflow is not big enough in absolute terms. Since 1997 the amount of FDI in this industry has been fluctuating enormously. Foreign investment has been increasing until 2001 and then started to fall since 2006 and later again grew. In 2013, the highest FDI amount of US$ 412.43 million was recorded. The amount as a share of total inflow has been declining since 2002; however, the total inflow has been increasing. The major investing Multi-National Companies (MNC) in this sector are from the Republic of Korea; Hong Kong, China, Japan and India. Bangladesh's RMG industry still maintains a great potential for FDI.

For FDI in Bangladesh, another important industry is gas and petroleum. This sector also experienced fluctuating fortunes of foreign investment. In 1997, the amount of FDI in this sector was estimated at US$ 109.09 million whereas in 2013 only US$ 22.35 million of FDI was achieved, which is a great reduction. The highest amount of foreign capital inflow in the gas and petroleum industry of US$ 230.45 million was happened in 1998. After that the amount has been declining continuously except some years. In its latest, FDI of only US$ 22.35 million was received in 2013.

The Banking sector in Bangladesh acts as one of the most rising industries. Foreign investors have been injecting their capital since the 1990s when Bangladesh has started to adopt various financial liberalization reforms. The FDI share of the banking sector to total inflow is also larger than many other industries. In 1997, a total of US$ 115.88 million in foreign investment in the said sector was recorded. It was grown to US$ 139.95 million in 1998 and then started to decline. After a big shock within 2000 to 2004, FDI amount again started to recover. The latest FDI figure of the banking sector is US$ 268.53 million in 2013.

Bangladesh's telecommunication industry has been flourishing very fast and now it is the largest FDI recipient in the country. FDI in this sector also increased substantially since 2005. Until 2005, the sector received a marginal share of foreign investment. In 2005, US$ 261.89 million of foreign capital flow, which was the highest sector amount in the country, was recorded for the telecommunication industry. Later the amount has been rising until 2013, except 2012. In 2013, the latest amount was estimated as US$ 525.29 million, which is higher than any other sector in the country.

Inward FDI Flow of India

For the sake of discussion, inflow of FDI in India is divided into two stages: before reform and after reform. FDI data from 1980 to 1990 is presented in the table below and it is indicative that Indian FDI inflow increased from US$ 79 million in 1980 to US$ 252 million in 1989. Later there was a declining trend in 1990 and the receipt was only US$ 237 million. The major investing countries prior to reform were Germany, USA, UK, Japan and Switzerland. In 1981, these five countries invested together about 86% of total FDI in India. On the contrary, in 1990 USA, Switzerland, Germany, UK and Italy invested as the top countries and their combined share accounted for about 57% of total inflows.

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Table 2: Country-wise FDI inflows in India before Reform

Pre-Reform Period								
Year/Country	USA	Germany	Japan	UK	Italy	Switzerland	Others	Total Inflow
1981	2.6	6.2	0.7	0.8	0.1	0.5	1.6	12.5
1982	5.3	3.7	26.5	1.7	4.2	1.5	23.6	66.2
1983	13.7	4.8	15.9	9.7	1.1	1.1	14.7	61.0
1984	7.9	2.5	5.4	1.6	0.7	0.4	80.9	99.4
1985	32.3	9.6	12.7	3.0	5.6	0.7	38.1	102.0
1986	23.3	16.0	4.6	6.1	1.9	2.6	30.4	84.9
1987	22.8	7.6	5.3	6.5	2.3	6.8	31.8	83.1
1988	69.8	22.3	12.5	10.0	22.0	1.2	34.5	172.3
1989	38.3	74.2	5.4	20.6	4.3	4.8	47.6	195.2
1990	19.7	5.4	2.9	5.2	3.9	7.7	28.5	73.3
Country Total	235.7	152.3	91.9	65.2	46.1	27.3	331.7	949.9

Source: Akter, G. (2013).

It can be inferred that during the whole decade of 1980 to 1990, India saw a fluctuating trend in its overall FDI receipts. However, after reform measures have taken place, FDI into India got an upward shift both in total and country-wise inflow. During the post-reform period, Mauritius, USA, UK, Germany, Japan and Netherlands invested heavily in India. These six countries accounted for about three-fourth (71.58%) of the total FDI inflow in the period of 1992 to 2008. After 2008, FDI from Japan and UK increased rapidly; on the contrary, FDI inflows from USA and Mauritius have declined. During the period 2000 to 2014, the total FDI in India was USD 214169.30 million. The last table indicates top 15 countries with their cumulative FDI in India starting from April, 2000 until February, 2014. Mauritius ranks the top position with 36.51 percent of total cumulative FDI inflows during this period. Other major sources are Singapore (10.92%), United Kingdom (9.70%), Japan (7.46%), U.S.A (5.56%), Netherlands (5.22%), Cyprus (3.44%), Germany (3.03%), France (1.81%), UAE (1.24%), Switzerland (1.22%), Spain (0.83%), South Korea (0.65%), Italy (0.62%) and Hong Kong (0.56%).

Table 3: Country-wise FDI Inflow in India after Reform

Post-Reform Period												
Country/ Year	Mauritius	USA	UK	Germany	Netherlands	Japan	France	Singapore	Switzerland	South Korea	Others	Total Flow
1992-93	n.a	22	7	21	21	26	9	3	35	n.a	136	280
1993-94	n.a	99	98	35	47	37	10	10	23	n.a	45	404
1994-95	197	203	144	35	45	95	14	25	26	12	76	872
1995-96	507	195	71	101	50	61	n.a	60	n.a	24	351	1419
1996-97	846	242	54	166	124	97	n.a	76	n.a	6	446	2057
1997-98	900	687	n.a	151	159	164	n.a	n.a	n.a	333	562	2956
1998-99	590	453	n.a	114	53	235	n.a	n.a	n.a	85	470	2000
1999-2K	501	355	n.a	31	82	142	n.a	n.a	n.a	8	462	1581
2000-01	843	320	61	113	76	156	93	22	8	24	194	1910
2001-02	1863	364	45	74	68	143	88	54	6	3	280	2988
2002-03	534	268	224	103	94	66	53	39	35	15	227	1658
2003-04	381	297	157	69	197	67	34	15	5	22	218	1462
2004-05	820	469	84	143	196	122	44	64	64	14	300	2320
2005-06	1363	346	261	45	50	86	12	166	68	61	762	3220
2006-07	3780	706	1809	116	559	80	100	582	57	68	1014	8871
2007-08	9518	950	508	486	601	457	136	2827	192	86	2780	18541
2008-09	10165	1236	690	611	682	266	437	3360	135	n.a	2597	20179
1992-2008, Total	32808	7212	4213	2413	3104	2300	1030	7303	654	761	1092	72718
1992-2008, Share, %	45.12	9.92	5.79	3.32	4.27	3.16	1.41	10.04	0.90	1.05	15.02	100.00
2000-Feb. 2014, Total	78155.05	11898.61	20759.16	6481.09	11170.49	15968.61	3869.84	23373.38	2612.79	1391.19	38488.38	214169.30
2000-Feb. 2014, Share, %	36.51	5.56	9.70	3.03	5.22	7.46	1.81	10.92	1.22	0.65	17.92	100.00

Source: Planning Commission, GOI and Akter, G. (2013)

Sectoral distribution of FDI flows shows that services sector is one of the largest recipients. Services sector of India contributes about 55% of GDP. The sector includes Financial, Banking, Insurance, Non-Financial Business, Outsourcing, R&D, Courier, Tech. Testing and Analysis etc. FDI inflow in this sector has been continuously rising since the 1990s when economic policy reforms started to take place in the country. Services sector FDI has seen a steep rise in 2005, although sector FDI inflow until 2000 was very low. Cumulative FDI inflow from 2000 to 2014 was 390.38 billion, which is 18.41% of total inflow in the country.

Construction Development Sector that includes townships, housing, built-up infrastructure and construction-development projects *viz.* housing, commercial premises, resorts, educational institutions, recreational facilities, city and regional level infrastructure etc. recorded an amount of FDI of US$ 230.46 billion during January 2000 to April. 2014 which is 10.87% of the country's total inflows received. Similar to the services sector, the construction activities sector of India also shows a steep rise in FDI inflows from 2005 onwards.

Telecommunications is another big sector of FDI in India. The sector includes telecommunications, cellular mobile phone, basic telephone services etc. and received an amount of US$ 130.28 billion of cumulative FDI during 2000 to 2014 which is 6.14% of the total amount of inflow. Telecommunications sector ranks the third largest in terms of FDI inflow in the country and like other large sectors; FDI inflow in this sector also got a big push after 2005. The Telecommunications is one of the fastest growing sectors in India due to the fact that a lot of international players are bringing new technologies to India through entering the market.

The IT industry of India is regarded as one of the fastest growing sectors. Foreign investment in computer software and hardware related businesses have been growing very fast with more international companies and MNCs entering the IT industry. Cumulative FDI inflow in the Computer Software and Hardware sector was about US$ 127.11 billion and it is about 5.99% of total inflow during the period of 2000 to 2014. It is expected that more and more foreign firms will invest their capitals in this sector during the coming years.

Drugs and Pharmaceuticals and Chemicals other than fertilizers are two promising FDI recipients in India. These two sectors received a total of US$ 209.63 billion cumulative FDI inflow during the said period and they combined accounted for 9.88% (Drugs and Pharmaceuticals 5.46% and Chemicals 4.42% respectively) of total inflow. The Pharmaceuticals industry of India is growing fast due to varied functions such as contract research and manufacturing, clinical research, research and development pertaining to vaccines by many multinational pharmaceutical corporations who prefer India to outsource these activities.

Automobile sector of India which comprises passenger cars, auto ancillaries etc. also is regarded as one of the booming industries. Cumulative FDI inflow in this sector has been estimated as US$ 93.44 billion which is 4.41% of the total inflow during the period from April 2000 to January 2014. Similar to most other sectors in India, FDI in automobile industry also got sharp increase after 2005. Major investing firms are from Japan, Italy, USA, Mauritius and Netherlands. The major companies that receive most of the automobile FDI in India are Yamaha Motors India Pvt. Ltd, Punjab Tractors Ltd., Yamaha Motor Escorts Ltd, Endurance Technologies P. Ltd, General Motors India Ltd, and Fiat India Automobile Pvt. Ltd.

Other sectors that get comparatively large amount of FDI are: Power with US$ 85.38 billion (4.03%), Metallurgical Industries with US$ 79.38 billion (3.74%), Hotel and Tourism with US$ 70.13 billion (3.31%), Petroleum and Natural Gas with US$ 54.91 billion (2.59%), Food Processing Industries with US$ 53.60 billion (2.53%),Trading with US$ 44.75 billion (2.11%), Information and Broadcasting sector with US$ 37.08 billion (1.75%), Electrical Equipment with US$ 33.0 billion (1.56%), Non-Conventional Energy sector with US$ 29.22 billion (1.38%), Cement and Gypsum Products with US$ 28.80 billion (1.36%), Industrial Machinery with US$ 27.52 billion (1.30%), Miscellaneous Mechanical and Engineering Industries with US$ 25.93 billion (1.22%), and Construction (Infrastructure) Activities with US$ 23.55 billion (1.11%).

Inward FDI Flow of Pakistan

FDI inflows to Pakistan have increased substantially since the 1990s when the country had adopted market-oriented investment policies. Pakistan's inconsistent investment policies until 1991 have resulted in low level in FDI inflow in the country. Starting from the 1990, a lot of policy reforms were adopted to encourage more overseas investment and as a result of these measures, inflow of FDI increased gradually during the post liberalization period.

The next table depicts FDI inflow to Pakistan since 1950 until 2011 and decadal data indicates that in the 1950-1959 decade, average FDI inflow was only US$ 4.14 million. Later it reached to an average of US$16.03 million in 1960-69. On the other hand, annual data shows that FDI inflow to Pakistan was recorded as only US$ 35 million in 1980-81 and later it has reached to US$246 million in 1990-91, to US$322.5 million in 2000-01, and finally to its highest value of US$5410.2 million in 2007-08. Then FDI inflow has showed a declining trend due to the lack of investment friendly environment in the country and in 2012 the amount was estimated to be US$1308.8 million. This major decline after 2008 was for the slowdown of global economy since the 2007-08 due to Asian Financial Crisis and other internal factors such as the threat of deteriorating security conditions inside the country.

FDI inflow as a percentage of GDP in Pakistan has been getting larger since 1950s except for the 2008 in a steady but slow pace. Growth of FDI inflow to Pakistan also turned to be insignificant until the 1990, the year when the liberalization was started to take place. However, as a result of reform activities through eliminating various regulatory regimes, the rate of growth accelerated and FDI started to play important role to the country's overall development.

Table 4: FDI Inflows in Pakistan, from 1950-2011

Year	FDI (in million USD)	FDI as % of GDP
1950-1959 avg.	4.14	0.099
1960-69 avg.	16.03	0.236
1970-76 avg.	28.74	0.163
1976-77	10.7	0.2
1977-78	35.5	0.19
1978-79	36	0.12
1979-80	28.2	0.13
1980-81	35	0.3
1981-82	98	0.15
1982-83	42.1	0.15
1983-84	48	0.23
1984-85	93.7	0.46
1985-86	161.2	0.32
1986-87	129	0.42
1987-88	172.7	0.53
1988-89	217.4	0.54
1989-90	216.2	0.54
1990-91	246	0.69
1991-92	335.1	0.6
1992-93	306.4	0.68
1993-94	354.1	0.73
1994-95	442.4	1.74
1995-96	1101.7	1.1
1996-97	682.1	0.97
1997-98	601.3	0.75
1998-99	472.3	0.77
1999-2000	469.9	0.55
2000-2001	322.5	0.82
2001-2002	484.7	1.17
2002-2003	798	0.98
2003-2004	949.4	0.99
2004-2005	1524	1.38
2005-2006	3521	2.77
2006-2007	5139.6	3.57
2007-2008	5410.2	3.41
2008-2009	3719.9	2.42
2009-2010	2205.7	1.33
2010-11	1308.8	0.62

Sources: Khan, A. H. (1997) and Handbook of Statistics on Pakistan Economy; State Bank of Pakistan, Statistics & DWH Department.

The major investing countries are the USA, UK, UAE, Hong Kong, Switzerland and Japan. FDI inflow from the USA and other countries such as Japan, Switzerland, Norway and Hong Kong has risen noticeably despite some considerable fluctuations. FDI inflows originated mainly from USA, UK, UAE, Saudi Arabia and Germany. In 2009, the top three investors were the USA with 23.39%, the UK with 7.08% and the UAE with 4.79% of total inflows. The shares for Other big sources such as Germany, Japan, Hong Kong, Saudi Arabia, China and Switzerland have been 1.66%, 2.00%, 1.92%, 4.28%, 2.73% , and 6.11% respectively.

About sector distribution of FDI in Pakistan, the most attractive sectors for foreign investment are agriculture, IT and telecommunication, power and services etc. The government of Pakistan offers 100% equity investment in almost all of the commodity producing sectors except arms and ammunitions, high explosive items, radioactive substances, and security and currency printing industry. Pakistan has adopted relaxed investment policies through offering various incentives such as tax exemptions, evading double taxation on income, permission to have 100% ownership by foreign firms in many sectors and equal investment opportunities for all investors from home and abroad etc. Through these liberalization measures the government has opened up the economy to foreign trade and FDI. The commodity producing sectors such as oil and gas, financial businesses and Communication are the major recipients of FDI. Trends in almost all of the sectors shown below indicate a fluctuating pattern of FDI inflow in the country.

The data shows that FDI inflows over the last 14 years in Pakistan were increasing for most of the sectors but with fluctuations. The services sector emerged as the largest sector to attract the major portion of FDI. Within the services sector the telecommunication industry receives major chunk of foreign capital in the form of FDI in Pakistan. In 2013-14 fiscal years, telecommunication sector got US$ 583.3 million of total FDI but the largest inflow in this sector was US$ 1937.7 million in 2005-06.

Financial sector in Pakistan is the second major FDI contributor after telecommunication sector. FDI in this area has increased from a mere US$ 3.6 million in 2001-02 to its highest amount of US$ 1,864.90 million in 2007-08. The financial sector reforms such as liberalization and privatization of the sector has acted as the driving force of massive inflow of FDI. Later inflow has reduced gradually due to global financial crisis and other reasons such as Pakistan's exclusion from the MSCI Emerging Markets Index. The latest estimated financial sector's FDI amount was US$ 156.8 million in 2013-14.

Power generation presents immense potential for investment and has attracted significant amount of FDI. Starting from US$ 39.9 million of FDI in 2001-02 the highest amount of FDI was seen as US$ 320.6 million in 2005-06 fiscal years. Later the sector has experienced a steep reduction due to a decline in investors' confidence for oil price shock and considerable power theft in Pakistan. In its latest, the sector has received US$ 46.6 million of FDI in 201.

Another emerging sector for FDI is Oil and Gas Exploration. Pakistan has a great potential in this sector because of its large reserve of coal. Every year the country mines only a mere 4.5-5.0 million tons of coal from a total of about 184 billion tons. Foreign investors see significant potential in this sector to invest. Hence, FDI inflow in this sector is continuously increasing. The highest amount sector FDI inflow of US$ 775.0 million was recorded in 2008-09. Later, for many reasons, inflow has reduced but still this is a large FDI earning sector in Pakistan. According to the Pakistan Board of Investment data, FDI in the Oil and Gas sector was US$ 465.1 million in 2013-14. Other important sectors that get a good share of foreign capital in Pakistan are Trade, Automobiles, Chemicals, Transport, Textiles and Construction industry.

Inward FDI Flow of Sri Lanka

Sri Lanka's inward looking policies until 1977 had retarded free flow of foreign investment due to various restrictions imposed by the government. Prior to liberalization of the economy only a few initiatives were taken place to attract FDI. Among these steps, the white paper for FDI in 1966 and the creation of foreign investment advisory committee in 1968 were the most appealing. Later in 1977 when the country accepted market based policies, liberalization of the FDI regime was also occurred and then the Investment Act of 1978 came to the front as a viable engine of FDI growth in Sri Lanka. Moreover, the Board of Investment was established in 1992 to attract more FDI flow to the country. As a result of these initiatives, many foreign companies started to invest in Sri Lanka and at present the number of foreign firms that are operating in Sri Lanka has exceeded 1000. The current FDI policy regime of Sri Lanka is very investment friendly and FDI laws are very transparent. For an instance, all of the earnings, profits, and capital proceeds of investors enjoy no repatriation (Athukorala, 2003). The data table below gives a clear idea about FDI inflows in million US dollar and FDI as a percentage of GDP since 1970 until 2012 for Sri Lanka. Inflow of foreign investment in the country has increased remarkably. Notable progress of FDI inflow was first seen in the 1978 and then again in 1992.

Table 5: FDI Inflows of Sri Lanka (1970 to 2012)

Year	FDI (in Million US$)	FDI (% of GDP)
1970	(0.30)	-0.01
1971	0.30	0.01
1972	0.30	0.01
1973	0.50	0.02
1974	1.40	0.04
1975	0.14	0.00
1976	0.001	0.00
1977	(1.22)	-0.03
1978	1.47	0.05
1979	46.90	1.39
1980	43.01	1.07
1981	49.26	1.12
1982	63.57	1.33
1983	37.78	0.73
1984	32.61	0.54
1985	26.16	0.44
1986	29.72	0.46
1987	59.50	0.89
1988	45.72	0.66
1989	19.74	0.28
1990	43.36	0.54
1991	48.34	0.54
1992	122.63	1.26
1993	194.48	1.88
1994	166.41	1.42
1995	155.99	0.43
1996	119.87	0.86
1997	430.06	2.85
1998	193.42	1.22
1999	176.41	1.13
2000	172.94	1.06
2001	171.79	1.09
2002	195.50	1.15
2003	228.72	1.21
2004	232.80	1.13
2005	272.40	1.12
2006	479.70	1.70
2007	603.00	1.86
2008	752.20	1.85
2009	404.00	0.96
2010	477.56	0.96
2011	955.92	1.62

Source: International Monetary Fund, Balance of Payments database, supplemented by data from the United Nations Conference on Trade and Development and official national sources. Data set was downloaded from http://www.indexmundi.com/facts/sri-lanka/foreign-direct-investment on 26th October, 2014.

Sector distribution of FDI in Sri Lanka shows that in the past FDI inflow was dominated mainly by the manufacturing industry. However, starting from the 1990s, the services sector began to receive large share in inward FDI due to the initiatives taken by the Sri Lankan government to liberalize the country's FDI regime. In 2010, 48.3% of the total inflow was in the services sector while other sectors such as manufacturing and agriculture got 30.9% and 1.2% respectively. Among the manufacturing sector, The Textile and Clothing industry is remained as one of the most important sector as an FDI recipient in Sri Lanka. Infrastructure and Telecommunication are another two very important FDI destinations for the country. Most of the services sector's FDI goes to construction, energy, telecommunications, and port services. In recent years some labor-intensive industries such as footwear, travel goods, plastic products, gems and jewelry, rubber-based products and ceramics are receiving increasingly large share of FDI. On the other hand, Agriculture sector has been suffering shrinkage in FDI grant in Sri Lanka since the 1990s.

Table 6: Sector-wise Distribution of FDI in Sri Lanka

Year	Manufacturing	Services	Agriculture	Total
In Million US$				
1995	61.3	39.5	16.7	117.5
1996	40.5	146.6	16.7	203.8
1997	72.4	189.8	1.8	264.0
1998	74.0	173.7	9.1	256.8
1999	62.9	211.9	3.6	278.5
2000	91.3	195.3	2.0	288.6
2001	43.1	17.2	4.0	64.3
2002	71.2	52.7	1.9	125.8
2003	38.4	165.6	9.5	213.5
2004	82.2	23.9	3.2	109.3
2005	135.3	151.3	0.4	287.2
2006	234.7	368.1	0.6	603.6
Percentage of Total Inflow				
Year	Manufacturing	Services	Agriculture	
2000	18.3	17.1	n.a	
2005	47.1	42.6	0.2	
2006	38.9	50.0	0.1	
2007	23.7	59.6	0.1	
2008	21.3	66.3	0.3	
2009	27.3	57.9	0.6	
2010	30.9	48.3	1.2	

Source: Dushni, W. and Weerakoon, J. T. (2009)

Economic Reforms and Their Impact on Inward FDI in South Asia

Economic reform initiatives in SA in the 1980s and early 1990s came out as implementation of a package of Structural Adjustment Policies (SAP) under the support of the World Bank and the IMF. Some examples include World Bank's Structural and Sectoral Adjustment Loans (SAL and SECLs) in 1980s. Reform programs include trade liberalization, agricultural reforms, privatization, financial sector reforms, and fiscal reforms (Bashar & Khan, 2007).

SA countries exercised a logical sequence in reform activities towards trade liberalization by initiating the relaxation and withdrawal of import quota restrictions along with the unification of the exchange rate and devaluation of the domestic currency. Starting from the mid-1980s tariff and non-tariff barriers were reduced substantially—the un-weighted average import duty rate declined enormously. However, cuts in custom duties were offset by other protective measures like Para-tariffs (World Bank 2004). The nations of the region reduced protection to make import less costly and helped the export sector to demonstrate stellar performance. As a result, economies in SA have achieved a great expansion in international trade as they opened and liberalized gradually during the 1980s and the early 1990s. Therefore, total volume of export and import as a share of GDP has grown significantly. Both export and import shares have been increased notably after trade reform initiatives were implemented.

Removing distortions from the economy imposed by regulatory authorities was the background of the Financial Sector Reform Programs in the region. For an example, some of the governments in the region created the comprehensive Financial Sector Reform Programme (FSRP) in early 1990s and mandated the authority to design policy aimed at liberalizing the economy through bringing indirect control in monetary policy, enhancing efficiency of financial institutions especially the banking sector, and restoring order in the financial sector (Bahar, 2009). Financial reform is important in SA because Capital markets are yet to be expanded and flourished in almost all SA countries. Like other developing countries banks and other financial institutions act as key intermediaries to provide necessary funds for businesses. Thus the contribution of financial liberalization reform to improvement of the productivity of domestic capital in these economies is a crucial factor (King & Levine, 1993; Hallwood & MacDonald, 1994).

Most of the countries in South Asia including Bangladesh, India and Pakistan opened their doors for foreign entrepreneurs during 1980s and the early 1990s in order to reap the benefit of overseas capital and investment. The countries built up Board of Investment (BOI), lifted restriction on capital and profit repatriation, and opened the industrial sector for FDI. Other measures that were also added were: tax exemptions for investors in some key industries such as power generation, withdrawal of import duties from export oriented machineries, offering tax holiday schemes for investment in priority and less developed sectors, reducing restriction on entry and exit, and lowering bureaucratic barriers in getting approvals of foreign projects.

Fiscal policy in various South Asian countries includes earning and spending activities carried out by the State to allocate resources in various sectors in order to provide services while ensuring optimum efficiency of the economic units. In the early stage of independence of the countries in SA, majority of the government expenditure was put in reconstruction and rehabilitation works. Notwithstanding, the situation changed gradually to improve the fiscal front—a number of fiscal reforms were undertaken in accordance with the IMF's Enhanced Structural Adjustment Facility (ESAF). For an instance, the introduction of Value Added Tax (VAT) that largely replaced the earlier version of differentiated sales tax in Bangladesh was one of the most important measures for the country's reform policies. On the expenditure side, vis-à-vis, increased emphasis was given on human resource development and poverty alleviation programs in most of the economies of SA. The governments of the individual countries have given top priority on the education sector to improve quality and coverage. The provision of health and family planning services and social safety net programs to serve the vulnerable people were also emphasized in government fiscal policies (Bahar, 2009).

After about three decades of the reform measures have been adopted, one question arises in general: is there any impact of these reform initiatives to promote inward FDI in SA? By utilizing an empirical estimation we try to find out the answer. More clearly, we will make an effort to empirically test whether the marginal impacts of reform measures are effectively lifting FDI for SA countries. We use the following regression equation to estimate the impact of economic liberalization reforms on inward FDI of South Asian countries by utilizing a panel fixed effects model:

$$Ln(FDI_{i,t}) = \mu_0 + \mu_1 Ln(PCY_{i,t}) + \mu_2 Ln(OPN_{i,t}) + \mu_3 Ln(FDI_{i,t-1}) + \mu_4 Ln(RIR_{i,t}) + \mu_5 Ln(MCY_{i,t}) + +\mu_6 \ln(TAXRY_{i,t}) + \mu_7 Ln(GNEXY_{i,t}) + U_{i,t}$$

For the above equation, *PCY* represents per capita GDP; *FDI* implies net inflow of foreign direct investment; the variable *OPN* represents the trade openness indicator in the form of total volume of export and import as a share of GDP, *RIR* stands for real rate of interest which is the financial openness indicator; *MCY* is Market capital as a share of GDP— it acts as a capital account openness indicator, *TAXRY* is Tax Revenue as a percentage of GDP, *GNEXY* is Government Expenditure as a share of GDP. *TAXRY* and *GNEXY* are proxy variables for fiscal reforms. *U* is for error terms. In order to perform regression of the equation, we use panel fixed effects technique. We use data of 5 countries from South Asia such as Bangladesh, India, Nepal, Pakistan and Sri Lanka. We do not include Afghanistan, Bhutan and Maldives in our estimation because of data restriction. The time horizon for the data is from 1991 to 2012. Data are collected from the World Development Indicators of the World Bank, the Asian Development Data Source and the United Nations Conference on Trade and Development (UN Comtrade Database)

Our empirical estimation for impact of economic reforms on inward FDI in South Asian countries was done by the panel fixed effect regression estimate. The results show that trade openness, lag of FDI and gross national expenditure have been positive while per capita GDP, real interest rate and tax revenue appeared to be negative. The variables such as lag of FDI and real interest rate were significant at 1% level while per capita GDP, tax revenue and gross national expenditure were significant at 5% level. The empirical findings are summarized below.

Table 7: Result Summary of Fixed-effects (within) Regression for Impact of Reforms on FDI
(Dependent Variable: FDI as percentage of GDP)

Variables	Explanation	Coefficient
lncpy	Per capita GDP	-0.0398**
		(0.0197)
lnopn	Openness Indicator (Total Trade as percentage of GDP)	0.0135
		(0.0317)
lnlagfdiy	Lag values of FDI as percentage of GDP	1.5403***
		(0.0391)
lnrir	Real Interest Rate	-0.0854***
		(0.0281)
lntaxry	Tax Revenue as percentage of GDP	-0.0949**
		(0.0456)
lngnexy	Gross national expenditure as percentage of GDP	0.6684**
		(0.2795)
Constant		-2.5643**
		(1.2196)
Observations	109	
R-squared	0.9695	
Number of Panels	5	

Robust standard errors in parentheses *** $p<0.01$, ** $p<0.05$, * $p<0.1$

Source: Author's Estimation

Policy Conclusion

According to neo-classical growth advocates, in a capital shortage economy, the marginal productivity of investment is increased if additional capital is injected in the form of long-run investment like FDI (Adhikary, 2011). On the other hand, endogenous growth economists postulate that such increased efficiency of investment which is achieved through more foreign capital investment is capable of providing comparative advantage (Romer, 1986). Moreover, in low-income countries FDI and foreign capital act as a source of fund in order to fill up the gap between existing level in resources and the amount needed in the development endeavor. Such funds stimulate productivity through complementing scarce domestic resources, by easing foreign exchange constraints, through inviting modern technologies and managerial skills, and also in facilitating easy access to foreign markets (Adhikary, 2011).

The influx of foreign capital flow, which had been expected to accelerate growth in some new and emerging industries, has not occurred in SA. To support a higher growth environment in the countries of the region by compensating for domestic resource constraints, little foreign investment is occurring and some companies, who have invested previously, are leaving because of a corrosive business environment. Institutionalized corruption in all government organs, political instability, poor management in transportation, inadequate infrastructure, and above all a crisis of wise leadership are some reasons. In order to achieve valuable foreign capitals such impediments should be eliminated.

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