Political Economic Digest Series- 16

Dear Political Economic Digest Series participant,

In the last issues of Political Economic Digest Series we discussed about Minimum Wage which is becoming one on the major issue in Nepal and all over the world. In this issue, we will be discussing about Foreign Direct Investment (FDI).

Foreign Direct Investment has been a very productive tool for the economic growth of many countries. Recently after the government made the decision to celebrate 2012/13 as investment year and after the agreement with India i.e. Bilateral Investment Promotion and Protection Agreement, the topic of Foreign Direct Investment has been highly discussed among the lawmakers, policymakers and general public. The examples provided in this issue of different countries regarding FDI has shown how the growth rate is positively affected by the investment from outside the country.

Foreign Direct Investment - Trends and Advantages

The United Nations Conference on Trade and Development (UNCTAD) reported in the end of October 2010, which Foreign Direct Investment (FDI) had significantly reduced in this year till now, as compared to the statistics for previous years.

The UNCTAD, established in 1964, has as its aim the participation of developing countries in the global economy to improve their economic status. It views foreign direct investment in developing countries as beneficial for the growth of these countries. It also gathers statistics and analyses various facets of the world economy.

According to the UNCTAD, foreign direct investment into developing economies would be totally the same as in 2009, dashing hopes of any increase this year as had been predicted previously.

The UNCTAD director of investment and enterprise division, James Zhan, also mentioned worries about further impact on FDI levels due attempts by countries to devalue their currency. The UNCTAD director expressed fears of a currency war where countries push down the value of their currency to attract more FDI. However, this can also affect a multinational company's profits.

According to statistics from Global Investment Trends Monitor, a global FDI analysis released periodically by the UNCTAD, foreign investments in the second quarter reduced by 25% compared to the previous quarter of 2010. Compared to the data for the same period in the year 2009, the investment levels had come down by 15%.

The Global Investment Trends Monitor noted increased FDI in Russia and China, and a decrease in FDI inflows in other developing countries. The levels of FDI in 2010 will remain much lower than what it was before the global financial crisis.

Why is Foreign Direct Investment (FDI) so important? How does it benefit both investors as well as the countries in which they have invested? Let's take a look at the concept of FDI in a global economy and some of the advantages of foreign direct investment. We will also review the FDI scenario in Chile as an example.

What is Foreign Direct Investment (FDI)?

Instead of investing in local businesses, putting money in a company functioning or incorporated in another country is foreign direct investment. For the country which is attracting the investment, the investor is a considered a "foreign direct investor". The foreign direct investor can have influence in the management of the companies invested in.

The foreign direct investor may have a varying amount of stake in the invested company - stakes can be as low as 10% or may also cross 49% of the shares or stock ownership. Some countries may have caps on the amount of equity a foreign direct investor may hold. For example, the Reserve Bank of India allows foreign equity only up to 50% in investment in specific mining sector in India. It totally forbids FDI in mining of iron and manganese.

The foreign direct investor seeks to have a controlling stake in the entity invested. This distinguishes it from an ordinary foreign investment.

The flow of capital from the foreign investor to the company invested in becomes an FDI inflow. FDI has three parts - equity capital investment, reinvested earnings and intra-company loans.

Advantages of Foreign Direct Investment

In the global economy today, we see many developing countries competing for foreign direct investment. FDI is said to be an important factor for spurring the development of a nation.

Let's take a look at some advantages of foreign direct investment to a host country:

Integration into global economy - A developing country, which invites FDI, can gain a greater foothold in the world economy by getting access to a wider global market.

Technology advancement - FDI can introduce world-level technology and technical know-how and processes to developing countries. Foreign expertise can be an important factor in upgrading the existing technical processes in a host country. For example, the civilian nuclear deal between India and the United States would lead to transfer of nuclear energy know-how between the two countries and allow India to upgrade its civilian nuclear facilities.

Increased competition - As FDI brings in advances in technology and processes, it increases the competition in the domestic economy of the developing country, which has attracted the FDI. Other companies will also have to improve their processes and products in order to stay competitive in the market. Overall, FDI improves the quality of a products and processes in a particular sector.

Improved human resources - Employees of a host country in which there is an FDI get exposure to globally valued skills. The training and skills upgradation can enhance the value of the human resources of the host country.

The advantages of foreign direct investment to the investor includes access to a larger market in the host country, ability to tap the potential of a cheap and skilled labour, making use of resources in the host country and pursuing growth goals by diversification and optimising costs.

Sample Case - Chile International Foreign Direct Investment

Chile has been in the news recently for the dramatic rescue of several miners trapped several hundred feet underground in a gold mine. The world praised the efficient manner in which the rescue was conducted. Many commentators also noted how the positive image would help Chile international foreign direct investment inflows.

Chile international foreign direct investment seeks to take advantage of the natural resources in the country. Chile has been an FDI-friendly nation in Latin America.

The Economic Commission for Latin America and the Caribbean (Eclac), an agency of the United Nations, reported that FDI in Chile was the third largest for South America, with an inflow of USD 8.03 billion.

The foreign direct investment in Chile in the year 2009 was USD 6.21 billion. FDI has continued in sectors such as mining. Factors such as the availability of raw materials have attracted FDI in the mining sector in Chile.

Source: http://www.ilikeinvesting.com/general-investment-articles/foreign-direct-investment.php

Foreign Direct Investment – Success Stories

China

Attracted by the country's investment opportunities and by its sheer size and growing domestic market, China received about 20 percent of all FDI to developing countries over the last 10 years and over $100 billion in 2008. In terms of share of GDP and investment, FDI accounted for some 2.5 percent of GDP on average over the last five years. While this may appear to be low it can be easily explained by the overall size of the economy: China is the third largest economy of the world, just behind Japan and the United States of America.

Inbound FDI has played an important role in China's economic development and export success. According to the Ministry of Commerce (MOFCOM), foreign invested enterprises account for over half of China's exports and imports; they provide for 30% of Chinese industrial output, and generate 22% of industrial profits while employing only 10% of labor – because of their high productivity. Evidence on technology spillovers is more limited, but industries with higher FDI seem to have higher productivity increases than other industries, suggesting a positive effect. Importantly, foreign investment has catalyzed China's economic reform. Together, these contributions have supported China in maintaining a record-high 10 percent growth rate during most of the 1980-2010 period.

FDI policies in China have evolved alongside economic development and strengthened institutional capacity. A gradual and prudent approach has been taken in the process of liberalization. When market institutions were not fully in place in 1980s and 1990s, China experimented with opening up to foreign investment in selected coastal cities and in special economic zones/industrial parks with a focus on attracting export-oriented manufacturing FDI. Corresponding to China's shift of its development goal from an emphasis on GDP growth towards a more harmonious balanced development, China made a radical commitment to services liberalization in its accession to WTO. This has triggered a shift of FDI to service industries. By 2009, FDI in services increased 3 times from that in 2000, while manufacturing FDI in China increased 81 percent. Regional production networks in East Asia grew substantially in the past few years and were largely aligned with China as their center. The results have been extraordinary. Thousands of multinational corporations have invested in China. The latest UNCTAD report on World Investment Perceptions lists China in first place among the top 15 investment locations. Hong Kong SAR and Taiwan, China have traditionally been the most important sources of FDI, but the presence of investors from Japan, the USA, and Europe has grown over the years.

China has been quite open for FDI in almost all manufacturing and most service industries. But China has been circumspect in its gradual approach to liberalization to synchronize it with the development of institutional capacity. Arguably, this has served China well to weather the financial crisis. Looking into the near future there may be a case for further liberalization of backbone services such as finance and telecommunication.

China's highly decentralized FDI approval and policy implementation creates opportunities for healthy competition for FDI among local authorities but can also become cause of excessive red

tape and corruption. In such a decentralized environment transparency of regulation and open communication between Government and business community is of special importance. To this end, local governments are increasingly seeking to ensure the administrative and operational efficiency of the approval process. The most common practice is setting up "one-stop" facilities, which aim at allowing investors to conduct all procedures in one place.

The World Bank Group recently published its Investing Across Borders 2010 report. The report is a new study comparing regulation of inbound foreign direct investment across four topics for 87 countries. It presents indicators only on countries' laws, regulations, and practices affecting how foreign companies invest across sectors, start businesses, access industrial land, and arbitrate commercial disputes. As such its scope is intentionally limited. It does not cover all circumstances relevant for foreign investors. As stated in the report, for example, in addition to assessing the legal and regulatory framework, it is well established that investors value the economic size of the host country, its domestic market and proximity to important foreign markets, the potential for innovation, and the level and quality of government services; and an educated and skilled workforce. From the host country's point of view, the risk of negative externalities from foreign investments, such as environmental and social damage (especially if the poor are the ones affected) needs to be balanced with the opportunity of positive externalities that such investments can yield. The Country profiles of the report need to be read with that context in mind.

India

The Indian economy has been booming ever since India came out of the shackles of imperialism and emerged as a politically, socially as well as financially independent nation. Although India attained its freedom more than about sixty years ago, the emergence of the Indian economy on the global scene has been a rather recent development. This is because of the realization of the true economic growth potential of India, by the foreign investors as well as business houses. Till about the recent times. India continued to be a whole soul agricultural economy, which had been impregnated with various types of bureaucracy, exploitation and corruption. In spite of this, the westerners saw tremendous potential in India to develop as an economically strong adobe for investment and ploughing in of cash in order to start off a new venture. But till recently, there were various jurisdictions prevalent in the code of law in India that prevented the full strength inflow of foreign direct investment in India. But fortunately for all, the Indian government was quick to realize the actual potential embattled in the Indian economy and what was holding it back. Thus finally in the year 2005, the Indian central government passed a jurisdiction allowing a cent percent foreign direct investment into the Indian economy, in various sectors.

This was one of the major steps taken into the direction and it opened the doors for a number of foreign investors to come to India and plough in their money into various segments of the

market. The sectors of the Indian economy to benefit the most from this were telecom, automobiles, retail, real estate and construction business. Of lately, other sectors such as pharmaceuticals as well as chemicals have also seen the magic of foreign direct investment. There are still some sectors like arms and ammunitions, transport and railways etc, which are still prohibited to entertain any type of foreign investment.

Apart from the government laws and jurisdictions, there are various other factors behind the success of foreign direct investment initiatives in the country. The most crucial factors include the tremendous support base provided by India to aid the success of the projects laid out by these foreign investors. The unending supplies of electricity and water services and facilities are one of the most crucial components of these. This has been possible as India is blessed by nature with a host of ever flowing rivers, which are like the lifeline to every activity that takes place in India. Apart from this, various types of raw material desired by these manufacturing projects such as coal, metals, minerals etc. are available abundantly in India. Thus, the instant availability of these raw materials is crucial in saving any kinds of delays and cutting down cost. Another favorable factor in India is the availability of a large workforce, which majorly dwells in villages and rural areas of the country.

All these factors and more can be distinctly recognized as the various factors that have led to the success of the foreign direct investment initiatives in the country.

Pakistan

Talking about foreign direct investment (FDI) in emerging economies, former US Federal Reserve Chief Alan Greenspan says: “But clearly the Licence Raj (in India) has discouraged foreign direct investment. India received $7 billion in FDI in 2005, a sum dwarfed by China’s $72 billion. India’s cumulative stock of FDI at 6 per cent of GDP at the end of 2005 compares with 9 per cent for Pakistan, 14 per cent for China, and 61 per cent for Vietnam. The reason FDI has lagged badly in India is perhaps no better illustrated than by India’s unwillingness to fully embrace market forces. That is all too evident in India’s often statist response to economic problems. Faced with rising food inflation in early 2007, the response was not to allow rising prices to prompt an increase in supply, but to ban wheat exports for the rest of the year and suspend futures trading to ‘curb speculation’ — the very market forces that the Indian economy needs to break the stranglehold of bureaucracy.” (p. 322 of "The Age of Turbulence" by Alan Greenspan.)

Since Mr. Greenspan wrote the words above, the FDI in Pakistan has continued to rise and remains a success story. The total investment grew by 21.4 percent or 23 percent of the GDP and Foreign Direct Investment (FDI) posted a growth of 71 percent from US $ 3.5 billion to US $ 6.0 billion in 2006-07. The FDI represents a deeper and longer term commitment than portfolio

investments which tend to be less durable and less reliable. This has happened in spite of the continued political instability and security issues.

As Mr. Greenspan points out, this dramatic increase in FDI for Pakistan has been made possible by the Pakistani government's liberal policies of allowing foreign investments in many sectors of the economy and the ability of the foreign investors to repatriate 100% of their profits in US dollars. These profits have continued to rise as the Pakistani economy has boomed with the GDP doubling over the last 5 years.

Foreign investors sent $519 million as their profits abroad during first seven months of the current fiscal year as compared to $467.9 million of the corresponding period of 2006-07, depicting an upsurge of some 11 percent.

State Bank's statistics show that profit repatriation by foreign investors registered a significantly increase of $51.4 million during July-January of the current fiscal year. The major share of repatriation was seen in the power sector, in which foreign investors have made new investments during the last few years due to the power shortage in the country, reports the Business Recorder, a Pakistani financial daily newspaper.

One of the downsides of liberalization has been an upsurge in inflation in Pakistan which India has attempted to curb by actions such as banning export of wheat and suspending futures trading which Greenspan criticizes in his book. While India has succeeded in the short-term in controlling wheat prices, the longer term consequences of such policies are usually detrimental to the economy.

Source: http://southasiainvestor.blogspot.com/2008/03/pakistans-success-story-foreign-direct.html

Nepal Investment Year -2012/13 and the challenges

By: Saurav Sharma

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In this era of globalization, Foreign Direct Investment (FDI) has been one of the important sources of industrialization and job creation, and a major component in the economic growth of many third world countries. Their experiences have clearly shown the role such investments play in breaking the vicious cycle of poverty. The prime example of such changes is the transformation of our two neighboring countries — China and India, who rose from the status of extremely poor nations to being the current economic superpowers of the world. On the other hand, in Nepal, despite the end of the decade long insurgency years ago, the investment environment has not improved, but rather deteriorated constantly. In this scenario, the idea

forwarded by the Federation of Nepalese Chambers of Commerce and Industry (FNCCI) to celebrate 2012 and 2013 as 'investment year' to improve the investment climate and attract FDIs has been welcomed by all, including the present Maoist-led government. However, as optimistic as it sounds, various hurdles lie in the path of making the Nepal Investment Year 2012/13 (NIY-2012/13) a success. With 2012 closing in, a lot of homework needs to be done, if the plan is to be implemented effectively and desired results are to be achieved. The labor issues, lack of adequate infrastructures, effective implementation of rule of law, et cetera are just some of the challenges that would need to be addressed.

In the last couple of years, a number of business houses and industries have closed down. The recent closure of Surya Nepal's garment wing and problems faced by restaurants like Fire and Ice has had a negative impact on investors. They are losing confidence in the security of their investment in Nepal. This is why, investors — both local and foreign — are either pulling out their investments from Nepal or diverting it to other countries.

One of the main reasons for closure of businesses has been frequent labor strikes, unreasonable demands and politicization of labor unions. So, to lure FDIs and gain investor confidence, the labor law has to be revised to reduce politicization of labor unions, make laws investor-friendly, introduce policies like hire-and-fire, secure the working environment of the labors, et cetera. A lot can be learnt from the experience of countries like Ireland, Austria and Finland in solving labor issues. Creating an environment for dialogue between labor unions, business owners and the government and creating industrial estates and exports-zone, where unionization is restricted could be a start.

Lack of adequate infrastructure is another major hurdle. Lack of proper transportation and heavy load-shedding are also major hurdles. Power cuts for as long as 18 hours a day are unacceptable. The alternative is to install a backup system, which increases production cost, making products too expensive to compete in the international market. This subsequently reduces profit and wages, which in turn ignites the labor-employer struggle. Deregulating and securing investment in the hydropower sector could help mitigate this problem and increase the income of the country and create more jobs. Regular and proper maintenance of road networks along with rapid development of strategic market access is another important homework needed to make the NIY-2012/13 a success.

Various sources show that a day strike (bandh) costs Nepal Rs 1.98 billion and the industrial sector alone suffers a loss of Rs 386 million. Frequent bands at regional and national level are another big challenge facing the country's economy. General strikes are people's right. But, forcefully shutting down road-networks, businesses, offices, schools, et cetera and vandalizing private property is not only misuse but abuse of power.

Investors are most fearful about investing in a country whose policies are unstable and there are changes with every change in government or leadership. Learning lessons from Venezuela, where foreign investors lost huge investments when Hugo Chavez nationalized private property,

investors are skeptical about politically unstable countries. For this, securing people's lives and property in the constitution itself could be the first step. If these policies are implemented properly, the stability needed for FDIs to pour into our country in spite of the change in government or leadership, can be achieved.

Besides stability, the proper enforcement of laws and regulations are needed for the success of NIY-2012/13. Laws like contract laws, which are limited to paper, need to be publicized and strongly implemented. The policies, no matter how well written, are of no use if they are not be implemented properly.

Lastly, malpractices of the private sector like syndicates and cartels need to be checked and obliterated completely because practices like these hamper consumer's rights and the overall economy by discouraging competition in the market. Though syndicates and cartels are illegal by law, lack of proper enforcement of the law has been the biggest challenge in creating a competitive market, which is a must for a favorable investment environment.

(Writer is research assistance at Samriddhi, The Prosperity Foundation)

Question to think about:

1. Should we protect our national industries from foreign companies (do we have to promote "Made in Nepal" product)?

2. Would the industries in Nepal benefit from Foreign Direct Investment?