1.1 Introduction

Initially, cross country investment flows in the form of foreign direct investment (FDI) was considered as an international capital movement only. In the earlier economic literature, FDI was considered as an alternative form of capital. High inflow of FDI is treated as an alternative means to fill the gap prevalent in LDCs. In fact, prior to 1950, FDI was regarded as a subset of portfolio investment (Kindleberger, 1969). The proper explanation of FDI was attempted in the 1960s, when academicians tried to integrate the activities of MNCs with the theories of FDI (Rayome and Baker, 1995). Theories suggested that the efforts made by various countries to attract FDI are due to the potential positive effects associated with the foreign investment which leads to economic development in the host country. It was ascertain that FDI would increase productivity, bring in new technology transfer, managerial skills, and know how, and create international production networks, increase employment opportunities, and provide access to external market (Caves, 1996). FDI leads to a spillover of advanced technologies to local firms (Findlay, 1978). It is in this context the South Asian Association for Regional Co-operation (SAARC) countries have made various attempts to attract FDI.\(^1\)

Since their independence, a majority of the SAARC countries had been following import-substitution led growth model in line with the prevailing philosophy of 1950.\(^2\) But in mid 1970s the limitation of inward-looking growth model became obvious. Accordingly, Sri Lanka initiated export promotion led economic reforms during late 1970s. Bangladesh underwent an IMF prescribed Structural Adjustment Programme (SAP) in the mid-eighties, while India experienced a similar reform nearly a decade

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\(^1\) SAARC was formed in 1985. It consists of Afghanistan, Bangladesh Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka (SAARC Secretariat)
\(^2\) Import substitution policies were undertaken to reduce dependence on the foreign countries and subsequently attain self-sufficiency (Sahoo, 2006)
later. Nepal undertook economic policy reforms in early nineties. Given the problem of surplus labour and capital scarcity faced by all South Asian countries in varying degrees, the economic reform process provided them an opportunity to actively promote inward FDI flows within the region.

As a result of the reform process undertaken by these countries, there has been a significant growth in the trade and investment flows in the SAARC region. For instance, the stock of FDI inflows which was only $1.07 billion in 1990 has increased to $10.12 billion in 2010, while the share of total trade which was 1.2% has increased to 8.4% in the same time period. Further, the numbers of MNC operating in the SAARC region has also increased significantly. However, despite the reform, the region has not received the full potential of the investment flows. Further, the region is yet to reach a sustainable growth level. The recent growth dynamics reveals that the GDP growth rate is greater than 6 per cent only for Afghanistan, Bhutan and India, but lower than 5 per cent in other countries. However, even in some of the better performers, the observed growth effect has not been broad based and remained concentrated in selected sectors only. The dependence on agricultural sector is still considerably high in countries like Bangladesh (18.73 per cent of GDP) and Nepal (33.85 per cent of GDP), with significant distributional implications. Though the manufacturing sector has been strengthened over the years, qualitative improvement is forthcoming. For instance, high-technology exports expressed as percentage of manufactured exports has been 8.60 per cent for India in 2009, but the corresponding figures for Bhutan, Nepal and Sri Lanka has only been 0.22, 0.42 and 0.92 per cent respectively. The decline in tariff barriers over the last decade has only marginally influenced intra-region trade patterns in South Asia, given the presence of the prevailing non-tariff and para-tariff barriers.

The performance of the region in the global trade-investment canvas has also been moderate. In 2009 the share of South Asian countries in global merchandise and commercial service export stood at 1.64 and 2.80 per cent respectively. The figure looks much more modest if India is removed from the list of member countries. On the other hand, the share of inward FDI in the GDP of Bangladesh, Bhutan, India and Sri Lanka has been 0.75, 2.85, 2.51 and 0.96 per cent respectively in 2009.

Foreign investment mainly consists of FDI. Accordingly in the current study FDI and foreign investment have been used synonymously.
The existing empirical literature indicates that regional integration arrangements considerably reduce trade costs among partner countries, which not only augment trade but also acts as a stimulus to FDI flow. It is widely accepted that trade and investment together function as a major catalyst for economic development if accompanied by favourable domestic policy. The less than potential integration of the South Asian region and the persistence of poverty and underdevelopment need to be viewed in this light. (OECD, 2002)

It is against the above background that in the present study an attempt has been made to analyse the investment flows in the SAARC region. An attempt has also been made to examine the relationship between investment and trade in the region.

1.2 Significance of the Study

FDI is considered to be one of the very important means for economic development of a country. Foreign direct investment brings modern technology, better managerial skills etc. along with the capital in the host country. The better technology and advance managerial skills bring competitiveness in the domestic industry, especially for the developing countries. The SAARC regions, where all the member countries are developing, have received large volume of FDI in the recent time. This large volume of investment has significantly impacted the region. Thus, it is of paramount importance to analyse the role played by the foreign direct investment in this region as a whole and also at the individual country level. Comparative analysis for each of the member countries is also important in this regard. It is in this context that the present study has the following objectives.

1.3 Objectives of the Study

- To examine the investment scenario in SAARC countries
- To assess the intra-regional flows of investment among the SAARC nations
- To analyse the link between trade and investment in SAARC region
- To assess the role of investment policy in attracting investment
- To examine the impact of institutional variables on investment flows in the region
1.4 Hypothesis

On the basis of the above objectives, the present study hypothesised the following.

1. After formation of SAARC, trade and investment has increased tremendously
2. Intra-regional investment flows and trade have grown more rapidly than inter-regional investment flows and trade.
3. Policy reforms have led to larger investment flows in the SAARC region.

The above hypothesis will be tested on the basis of the methodology explained in the next section. In order to make the study comprehensive, a time period from 2000 to 2010 has been considered.\(^4\)

1.5 Methodology and Sources of data

In order to analyse trade and investment relation in SAARC region, the study employed gravity model. The distinctive feature of the gravity model is inclusion of distance variable which measures geographical or cultural proximity between the two trading nations. The other distinctive parameters of the model are dummy variables, such as common official language, border, common colonial ties, country’s sea access etc. The model envisages that trade between two nations depends positively on the size of their economies while negatively on their distance. The size of the economy is measured in terms of GDP and population of the trading nations.

To investigate the presence and the direction of causality between investment and trade, the Granger causality model has been used. The Granger causality test was designed and developed by Granger (1969), Engel and Granger (1987) and Johansen (1991).

Under the Granger causality analysis there can be three different directions.

A.) One way causality: Under one way causality or in a single equation model, \(Y\) is the dependent variable and \(X\) independent. Here, there is a causality

\(^4\) Time period considered was based on availability of consistent data for SAARC countries
relationship from X towards Y (X-Y) Independent variable is the cause and causes a one-way effect on dependent variable, which shows the presence of one-way causality and the relationship is determined as (Y-X).

B) Two-way causality: There can be a reciprocal effect between variables. Both the variables follow each other.

C) Lack of causality: There is no relationship among variables, therefore no causality exist among them.

To examine the role of policy and institutional variables in attracting investment flows the study has applied Seemingly Unrelated Regression model. Zellner’s (1962) Seemingly Unrelated Regressions (SUR) approach is popular as it captures the efficiency due to the correlation of the disturbances across equations. There are two main motivations for using of SUR. The first one is to gain efficiency in estimation by combining information on different equations. The second motivation is to impose and/or test restrictions that involve parameters in different equations.

The study has used UN COMTRADE for collecting trade related data for all the selected countries. UN COMTRADE was accessed from the World Integrated Trade Solution (WITS) online database. Data for FDI inflows in the selected countries were extracted from UN statistics.

Data have been collected from local sources also. Secretariat for Industrial Assistance (SIA) News Letter of Department of Industrial Policy and Promotion, Ministry of Commerce, Government of India, was referred for collection of FDI inflow data in case of India. Various issues of Industrial Statistics, of Department of Industry, Government of Nepal were referred in case of collecting data for FDI inflows in Nepal. Website of State Bank of Pakistan (Central Bank) was accessed for the collection of FDI inflow data for Pakistan. Website of Department of Industry of Bhutan has been consulted for data regarding Bhutan. The Board of Investment, Sri Lanka and Board of Investment, Bangladesh provided the data in case of Sri Lanka and Bangladesh respectively. The study also used the Annual Reports of Sri Lankan Central Bank.
1.6 Limitations of the Study

Although SAARC was formed in 1985, due to lack of relevant and continuous data the analysis could be carried out only during 2000-2014. Further, the study is carried out only for six countries out of the eight member countries in the SAARC region. Afghanistan and Maldives have been excluded all together. In addition to that Pakistan and Bhutan were excluded in some sections of analysis in the study. Again, it is due to lack of availability of the comparable data we could not follow the same pattern of analysis in all chapters of the study. The study considered only FDI inflows. The analysis in the study is limited to the major investing countries and major sectors attracting investment in the region.

1.7 Chapter Scheme

The entire study has been divided into seven different chapters of different length. Each chapter deals with different themes in terms of the stated objectives.

Chapter 1: Introduction

The present chapter is the introductory chapter which provides the objectives and hypothesis of the research work.

Chapter 2: Theories of International Investment and Survey of Literature

In the second chapter of the study, the existing theories of international investment are presented. The chapter also provides a review of the empirical studies related to international investment flows. The studies examined indicate that the inflows of investment depend on number of factors like location, advantage over the domestic firm, brand name and many more. But no single theory can explain all the factors responsible for attracting foreign investment.
Chapter 3: Trends of Trade and Investment in SAARC Region

In this chapter the profile and trends in foreign direct investment and trade in the SAARC countries is presented. The same chapter also discusses the evolution of FDI policy in the member countries of the SAARC region. The chapter is divided into five sections for each member countries.

Chapter 4: An Analysis of Trade and Investment relationship in SAARC Region

The surge in the volume of world trade and foreign direct investment in the last two decades have attracted a debate amongst the researchers and policy makers on the issue of the relationship between these two. The major questions that arise are; how they are related? If related is the relationship supplementary or complementary to each other? i.e. whether FDI enhances trade or contracts trade? This issue has been taken care in this chapter.

Chapter 5: Causal Relationship Between Investment and Trade in SAARC Region: An Analysis

In the present chapter an attempt has been made to find the causal relationship between trade and investment. The analysis has been carried out for the entire region as a whole. The result of the analysis indicates that there is no causal relationship between trade and FDI among these SAARC countries.

Chapter 6: A SUR Analysis of Investment and Institutional Variables

Apart from policy reforms other institutional factors like business freedom, investment freedom, trade freedom, financial freedom, fiscal freedom etc. of the host country may also affect foreign investment. The role of these factors has been addressed in the sixth chapter of the study in the context of SAARC region.
Chapter 7: Summary and Conclusion

Finally, in the last chapter summary and conclusion have been provided. The findings of the study are also presented in this chapter along with their policy implications.
References


