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Impact of Foreign Direct Investment on Bangladesh's Balance of Payments: Some Policy Implications

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Abstract

Foreign direct investment (FDI) is a potent weapon of economic development, especially in the current global context. It enables a capital-poor country like Bangladesh to build up physical capital, create employment opportunities, develop productive capacity, enhance skills of local labor through transfer of technology and managerial know-how, and help integrate the domestic economy with the global economy. This study reports high positive correlation between FDI inflows and Bangladesh's aggregate exports and imports. The net impact on the current account balance and the balance of payments is positive. Bangladesh's investment incentives and regulations for FDI are found competitive with those offered by similar other countries. Effective implementation of these measures and success in attracting higher FDI inflows, however, needs significant institutional reforms, radically reduced levels of control, better provision of essential infrastructures, perceived improvement in investment climate, and sustained socio-political stability.

I. Introduction

Foreign direct investment (FDI) is a potent weapon of developing the Bangladesh economy and can play an important role in achieving the country's socio-economic objectives including poverty reduction goals. In a capital-poor country like Bangladesh, FDI can emerge as a significant vehicle to build up physical capital, create employment opportunities, develop productive capacity, enhance skills of local labor through transfer of technology and managerial know-how, and help integrate the domestic economy with the global economy. This policy note provides an assessment of the current situation of FDI in Bangladesh and examines its impact on the country's balance of payments.

II. Current Situation of FDI in Bangladesh

Since the last decade, there has been a considerable change in global flows of trade and finance including a surge in FDI. Despite being a recent phenomenon, several underlying factors have contributed to increasing the FDI inflow in Bangladesh, such as trade and exchange liberalization, current account convertibility, emphasis on private sector led development, liberalization of the investment regime, opening up of infrastructure and services to the private sector-both domestic and foreign, and above all the interest of foreign investors in energy and telecommunication sector. It is argued that more open trade policies are associated with the presence of foreign firms and economy-wide technological and productivity gains in developing countries like Bangladesh. There also exists evidence of a strong positive correlation between increasing share of FDI in GDP

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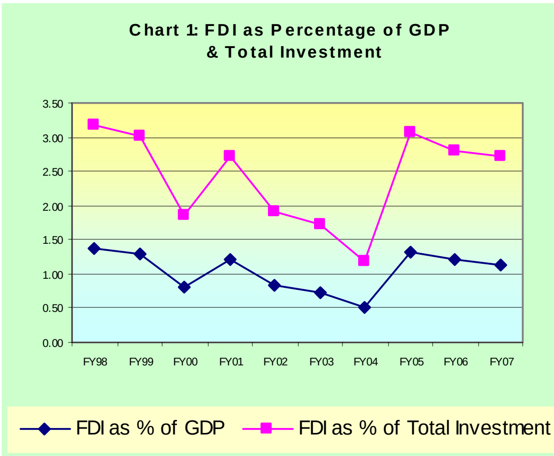
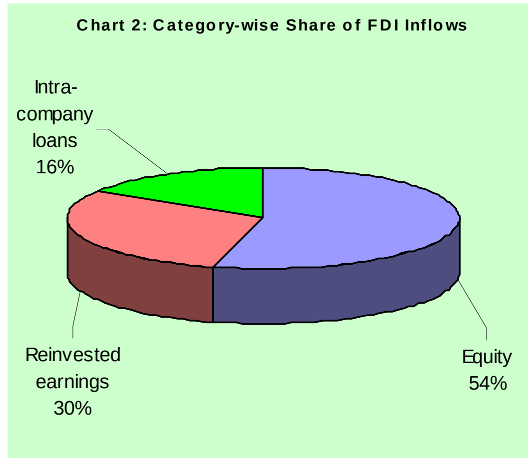
and diversification to high-technology exports in countries that have open trade regimes. Still, FDI constitutes a low share in GDP or gross investment of the country. Over the last decade, FDI as a share of GDP varied between 1.4 percent in FY98 and 0.5 percent in FY04. In FY05, the share rose to 1.3 percent due mostly to the large inflow of FDI to the telecommunications sector (Chart 1). As a ratio of gross investment, FDI varied between a low of 1.2 percent in FY04 and a high of 3.2 percent in FY98. Thus, given its low share in GDP and gross investment, it is expected that FDI is not likely to have a significant impact on various sectors as well as on important macroeconomic indicators of the Bangladesh economy.





The volume of FDI inflows to Bangladesh since FY98 is given in Table 1. Over the 1998-2007 period, the aggregate FDI inflow to Bangladesh was USD 5,510 million. Of this, equity was USD 2,986 million (54 percent), reinvested earnings amounted to USD 1,634 million (nearly 30 percent), and intra-company loans constituted USD 890 million (16 percent) (Chart 2). After a relatively high inflow in FY98, there was a declining trend in FDI inflow up to FY04 with an exception in FY01. In FY05, there was an abrupt growth in FDI inflow amounting to USD 804 million. However, when FDI and debt inflows are seen in the context of associated remittances on account of dividend/profit repatriation, disinvestments, and debt amortization, it is observed that over the 10-year period (1998-2007), the outward remittances constituted 65 percent of the total inflow.

Table 1: FDI Inflows and Associated Outward Remittances, 1998-2007

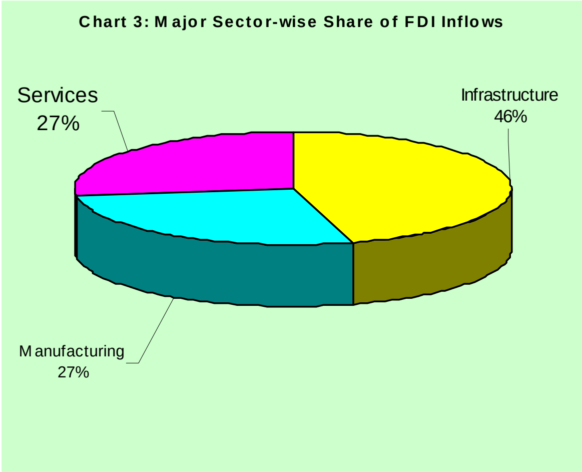
(million US dollars)

	FY98	FY99	FY00	FY01	FY02	FY03	FY04	FY05	FY06	FY07*	TOTAL
Total FDI inflows	603	594	383	564	394	379	284	804	745	760	5,510
Equity	349	396	153	372	230	164	111	361	447	403	2,986
Reinvested earnings	181	121	81	81	85	165	161	294	199	266	1,634
Intra-company loans	73	77	149	111	79	50	12	149	99	91	890
Outward remittances											
Dividend/profit repatriation	40	83	149	175	195	355	338	418	396	569	2,718
Investment liquidation	0.1	2.9	0.5	0.5	2.6	2.2	10.5	3.3	3.5	4.5	30.6

* Estimated, Source: Statistics Department, Bangladesh Bank.

It may be mentioned that the surge in FDI in the energy and telecom sectors in Bangladesh is associated with heavy import content and little impact on foreign exchange reserve accumulation. This also raises a long term concern relating to the country's ability to generate sufficient foreign exchange to finance remittance of profits and income originating from foreign investment. An associated concern is the rapid accumulation of foreign debt obligations of various maturities by the private sector; the outstanding stock of private-sector debt has now reached a significant level. The rapidly accumulating private sector debt gives rise to interest and principal payments in foreign exchange over and above official debt obligations to bilateral and multilateral agencies.

Sectoral distribution of FDI inflows



The sector-wise inflow of FDI during 1998 to 2007 is presented in Table 2. There are three broad sectors of FDI inflows: infrastructure, manufacturing, and services. The shares of the three sectors are 46 percent, 27 percent and 27 percent respectively (Chart 3). In infrastructure sector, gas and oil was the main recipient of FDI amounting to USD 1,241 million (22.5 percent). The flow was distributed more evenly across all years compared with other sectors. On the other hand, there was a high growth in FDI inflow to the telecommunication sector in FY05 which continued till FY07. In the manufacturing group, the most significant recipient was the textiles sector amounting to USD 903 million (16.4 percent) out of USD 1,374 million to the group. The third group is the services sector where FDI inflows amounted to USD 1,349 million during the period out of which trade and commerce was the highest recipient with USD 909 million (16.5 percent). The overall picture over the last ten years can be seen in Chart 4.

Table 2: Sector-wise Distribution of FDI Inflows, 1998-2007

(million US dollars)

Sector	FY98	FY99	FY00	FY01	FY02	FY03	FY04	FY05	FY06	FY07*	TOTAL
Infrastructure	238	249	106	319	197	120	131	461	478	488	2,287
Gas and Oil	231	124	50	139	75	23	61	169	182	187	1,241
Power	0	101	56	175	101	35	26	30	28	29	581
Telecommu-nications	7	24	0	5	21	62	44	262	268	272	965
Manufacturing	145	150	163	134	123	160	64	219	107	109	1,374
Textiles	117	129	144	113	67	77	32	75	74	75	903
Fertilizer	2	0	0	4	25	5	23	51	16	16	142
Cement	3	2	5	13	28	77	6	87	16	16	253
Chemicals & Phar-maceuticals	23	19	14	4	3	1	3	6	1	2	76
Services	220	195	114	111	74	99	89	124	160	163	1,349
Trade & Commerce	173	116	44	35	48	49	55	102	142	145	909
Other Services	47	79	70	76	26	50	34	22	18	18	440
Total	603	594	383	564	394	379	284	804	745	760	5,510

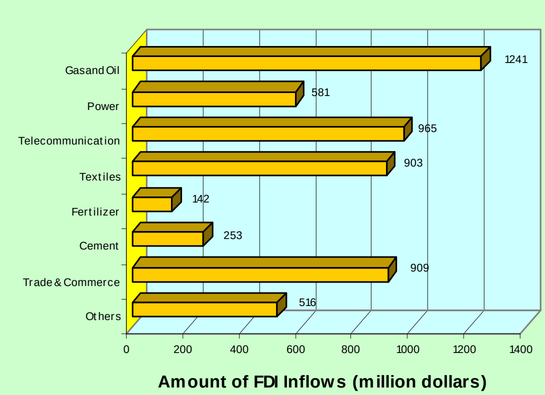
* Estimated, Source: Statistics Department, Bangladesh Bank.

Over the 1998-2007 periods, gas and oil, textiles, and trade and commerce dominated the first half in terms of FDI inflow whereas telecommunication sector was the highest recipient during the second half of the ten year period. On the other hand, gas and oil, and trade and commerce sectors showed better performance during the last two years but the textiles sector experienced declining inflow of FDI in the second half of the decade.

III. Impact on Balance of Payments

The economic impact of FDI on the level of economic activity has been widely investigated in recent years across different countries. Some results suggest that the inflow of FDI can 'crowd in' or 'crowd out' domestic investment depending on specific circumstances. Overall, FDI has a positive impact on economic growth but the magnitude of the effect depends on the availability of complementary resources, especially on the domestic stock of human capital.

Chart 4: Sector-wise Distribution of FDI Inflows



In Bangladesh, FDI inflows are reported under the capital and financial account of the country's Balance of Payments (BOP) statement which provides the direct effect on the BOP. Thus the inflow of FDI plays an important role in determining the surplus/deficit in the capital and financial account of the BOP statement. From the above, it can be said that the initial impact of an inflow of FDI on Bangladesh's BOP is positive but the medium term effect could become either positive or negative as the investors increase their imports of intermediate goods and services, and begin to repatriate profit.

After setting up capital machineries, the FDI-financed companies begin to export their products as most of these companies are export-oriented. Usually, FDI inflow tends to have a greater positive impact through augmenting exports than creating a negative impact through increasing imports. It is found that FDI-financed firms tend to export a greater proportion of their output than their local counterparts as these firms usually tend to have a comparative advantage in their knowledge of international markets, efficiency of distribution channels, and their ability to adjust and respond to the changing pattern and dynamics of international markets. Similarly, policies of creating Export Processing Zones (EPZs) contribute to strengthening the positive correlation between FDI inflows and exports. So, the inflow of FDI may play an important role in Bangladesh in the long run in reducing the deficit in the country's trade balance.

Empirical research in several countries suggests that the initial inflow of FDI tends to increase the host country's imports. One reason for this is that primarily FDI companies have high propensities to import capital and intermediate goods and services that are not readily available in the host country. However, if FDI is concentrated in import substituting industries, then it is expected to affect imports negatively because the goods that were imported earlier would now be produced in the host country by foreign investors.

In order to see the impact of FDI on Bangladesh's BOP, we estimated separate import and export functions for Bangladesh. The results of the estimated import demand function suggest that FDI increases imports faster by current inflow than with a lag of one year.[1] The co-efficient is statistically significant with a positive sign and suggests that a 10 percent increase in the inflow of FDI increases imports by 1.3 percent. The income elasticity of import demand is high indicating that a 10 percent increase in real GDP increases imports by nearly 27 percent.

Similarly, we estimated a simplified export function in order to see the impact of FDI on Bangladesh's exports.[2] This shows that FDI with a lag of one year increases exports faster than contemporaneous period. The co-efficient is significant with a positive sign

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[1] The estimated equation is:

$$\ln(IMP) = \underset{(-3.55)}{-17.887} \; \underset{(-1.91)}{-\,0.658} \ln(IPR) + \underset{(3.70)}{2.676} \ln(GDP) + \underset{(1.97)}{0.131} \ln(FDI) + \underset{(1.16)}{0.051} \ln(FDI_{-1})$$

$R^2 = 0.921$ DW = 1.53 SER = 0.061

where IMP is real demand for imports, IPR is relative price of imports (price of imports deflated by GDP deflator), and GDP is real GDP. Figures in parentheses are t values.

[2] The estimated equation is:

$$\ln(EXP) = \underset{(0.05)}{0.874} \; \underset{(-1.36)}{-\,2.353} \ln(XPR) + \underset{(1.69)}{2.184} \ln(GDP) + \underset{(0.75)}{0.060} \ln(FDI) + \underset{(3.25)}{0.162} \ln(FDI_{-1})$$

$R^2 = 0.895$ DW = 1.70 SER = 0.078

where EXP is real exports, XPR is relative price of exports. For other definitions, see footnote 1.

and suggests that a 10 percent increase in the inflow of FDI increases exports by 1.6 percent.[3]

The above results show that FDI contributes positively to increasing imports and exports and can either improve or deteriorate the country's trade balance depending on the relative magnitude of the two forces. However, with a. positive effect of FDI inflows on the financial account, it is more likely that the first round effect of FDI is positive on the BOP of Bangladesh.

IV. Conclusions and Policy Implications

Bangladesh has a number of positive attributes that can successfully attract the attention of foreign investors from both developed and developing countries. The increasing availability of skilled and unskilled labor at relatively low wages and the success in maintaining reasonably stable macroeconomic environment are a few factors behind making the country an attractive destination for foreign investors. They are generally aware that the wage rates in Bangladesh are among the lowest in Asian countries, the rate of inflation is usually contained within tolerable limits, the exchange rate is reasonably stable, custom regulations are investment friendly without discrimination between foreign and domestic investors, and attractive incentive packages are available for the foreign investors.

Bangladesh needs to undertake effective promotion measures to convince the potential foreign investors that their involvement in business activities in the country is valued, they would be facing friendly regulations, and they can enjoy investment incentives that are competitive with those offered by other countries in the region and the developing world. The country also needs to move forward through implementing investment-friendly policies, simplifying regulatory practices, and removing inefficient bureaucratic procedures.

Over the last decades, almost all developing Asian economies including Bangladesh have progressively adopted more open policies toward FDI and this trend is likely to continue in the foreseeable future. The general conclusion of this study is that FDI brings net benefit to Bangladesh. These benefits appear to be important for integrating the domestic economy with the global economy and in the area of technology and skill transfer.

The global experience suggests that, depending on the country context, the benefits of FDI are highly uneven and can become ambiguous or possibly negative. However, given its present characteristics, Bangladesh is likely to benefit through more FDI inflows. It is important, therefore, for Bangladesh to ensure an investment climate that can attract more FDI flows to the country. For the purpose, several policy areas are important that include:

- *Quality of bureaucracy and governance*: Appropriate reform measures are needed in the country's administrative system. The bureaucracy needs reorganization in order to bring about a perceptible improvement in its efficiency and productivity. Bureaucratic control and interference in business and investment activities should be minimized on a priority basis.

[3] For similar results in the case of Pakistan, see Khan and Kim 1999.

- *Improvement of law and order situation*: Law and order situation needs to be improved through appropriate reforms in law enforcement and introducing other measures. A social consensus is needed to establish the rule of law, avoid political confrontation, and reduce corruption.
- *Development of infrastructure and human resources*: Both the government and private sector need to come forward to invest in infrastructure development. For the purpose, appropriate policies are needed such that the private sector can smoothly operate in providing infrastructure services. Similarly, both public and private universities should come forward in introducing courses/programs that produce graduates with technical and management skills required in modern industrial and other activities. In this context, if the government and the private sector work together to implement effective economic reforms in a successful manner, Bangladesh stands a good chance of being able to participate in the prosperity and growth that are sweeping the rest of Asia.
- *Improvement of port services*: Despite recent improvements, the efficiency of port services can be further improved through appropriate measures. Similarly, the custom clearance procedures can be further simplified along with improvement in physical facilities and reforms in the labor management system.
- *Privatization and further reforms*: The privatization program of the state owned enterprises needs to be geared up that would stimulate domestic and foreign investments. Several financial institutions and some of the public utilities may be privatized in order to ensure better and more efficient services. The policies should encourage private sector participation in several key sectors like agricultural processing, manufacturing, infrastructure including transportation, telecommunication, power, port, and in the production of high value added products.
- *Modernization of business law*: It is important for Bangladesh to modernize and revamp all laws relating to business and investment keeping in view the international practices and requirements of globalization.
- *Setting up of industrial parks*: The development of new industrial parks can help in creating a favorable environment of foreign investment. The availability of ready infrastructure along with secure and enabling investment climate can act as a powerful catalyst in attracting foreign investors for investment in profitable ventures.
- *Setting up of new EPZs*: The government may come up with a phased program of setting up new EPZs in order to extend facilities to export oriented investors. The private sector may also be encouraged to set up new EPZs.
- *Improving the country's image abroad*: Positive developments regarding the country's economy, society, and future prospects, including the hospitable investment climate existing in the country and the facilities available to foreign investors, should be projected abroad in an effective manner, especially among the potential investors. Such 'image building' efforts would be crucial to dispel the negative images that have persisted for long and discouraged the investors to come forward. In addition to the above, maintaining consistency in policies and actions is important so that no 'wrong signal' is conveyed to the investors.
- *Policies regarding macroeconomic stability*: The government should implement appropriate policies to ensure macroeconomic stability in a sustained manner, foster growth promoting and growth accommodating policies, and undertake further actions to reduce poverty at a faster rate. Bangladesh has already achieved

notable success in this regard and achievements in both economic and social development should be actively publicized abroad to promote a positive image of the country among the prospective foreign investors.

- *Economic and commercial diplomacy*: Strengthening economic and commercial diplomacy is a key factor in attracting FDI in the present world characterized by rapid globalization and increasing competition. In this respect, improved bilateral relations with potential investor countries can act as a catalyst to increasing FDI inflows to Bangladesh. Moreover, it is important not only to improve relations with countries that have already invested in Bangladesh, but also to identify potential investors in other countries and undertake appropriate measures to attract them to invest in the country.

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