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Two sides of the Coin

The dynamic economic and investment policies executed by the Government of Pakistan in the recent years have increased the FDI inflows significantly. Total FDI for the first nine months of the current fiscal year stands at USD 3.86 billion; 72% higher than the amount of USD 2.24 billion for the corresponding period of the previous year.

This report will begin with a brief outline of the FDI regime in Pakistan before critically examining the impact of these inflows in developing economies, particularly in terms of efficiency spillovers and domestic investment. The monetary impact of FDI has already been discussed in the previous economic report; Issue 34 and therefore this report will only brush through this aspect. After analyzing the risks and benefits of FDI, the report will finally evaluate how FDI inflows have generated economic benefits in Pakistan.

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The FDI Regime

Till almost a decade ago, the Foreign Direct Investment (FDI) inflows in Pakistan stood fairly below the desired level. In 1995-96, the economy though registered FDI inflows worth USD 1.1 billion mainly on account of agreements with Independent Power Producers (IPPs), the inflows fell sharply in the following year as the successive government renounced agreements with IPPs. This gave rise to a row between the government and IPPs, which adversely affected foreign investor's confidence in Pakistan. Moreover the country's decision to go nuclear in 1998 prompted several foreign countries to impose economic restrictions which exerted further downward pressure on FDI inflows.

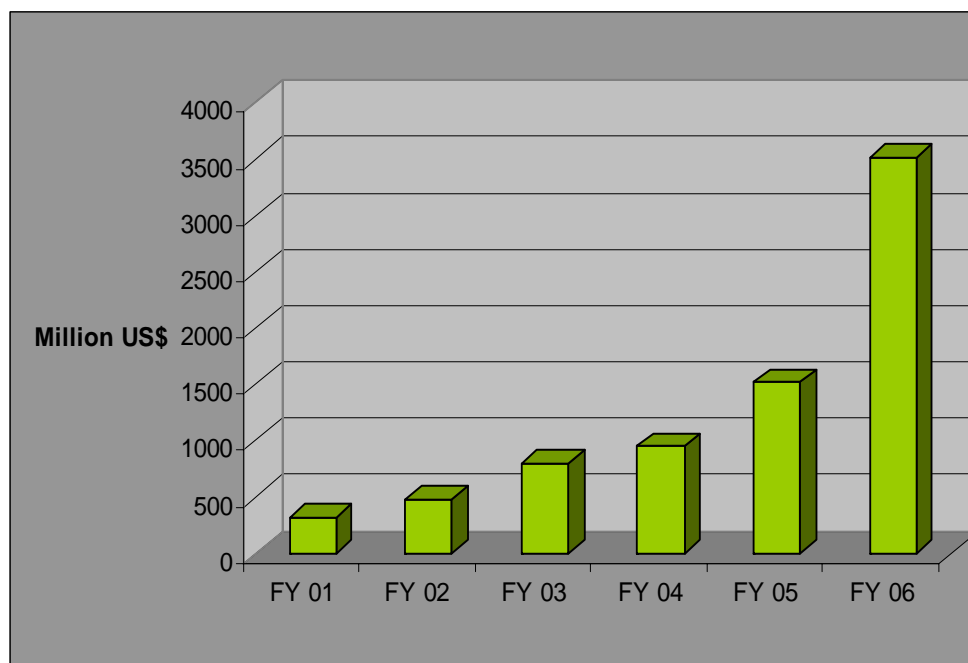
It was only during the last six financial years that the FDI levels improved significantly owing to the dynamic economic and investment policies executed by the government that included opening the economy through privatization and deregulation and establishment of a liberal FDI regulatory regime. This regulatory framework for foreign investment constitutes three laws: Foreign Private Investment (Promotion & Protection) Act 1976; Furtherance and Protection of Economic Reforms Act 1992; and Foreign Currency Accounts (Protection) Ordinance 2001. Taken together, these laws protect FDI in the following manner:

- There is freedom to bring, hold and take out foreign currency from Pakistan in any form.
- Fiscal incentives provided by the government cannot be altered to the disadvantage of the investor.
- The privatization of an enterprise is fully protected.
- No foreign enterprise can be taken over by the government.
- Original foreign investment as well as profits earned on it can be repatriated to the country of origin.
- Equal treatment is provided to a foreign investor and local investor in terms of import and export of goods.
- FDI is not subject to taxes in addition to those levied on domestic investment.
- Foreign currency accounts are fully protected and they cannot be frozen (courtesy the Foreign Currency Accounts Ordinance 2001).

Foreign investors are permitted to hold 100% of the equity in not only industrial projects but also in the Service, Infrastructure and Social Sectors (subject to certain conditions) on repatriable basis. Moreover, no government sanction is required for setting up an industry in terms of field of activity, location and size except in case of four sectors relating to national security. Under the deregulation policy, government controls on business activity are being relaxed even further. To avoid double taxation on income earned by foreign investors, Pakistan has already concluded agreements with 51 countries that include nearly all the developed economies.

As a result of these proactive policies, the FDI increased by more than 900% in the past six years. It crossed the USD 1 billion mark in FY 04 and is set to cross the USD 4 billion mark in the current fiscal year. Total FDI inflows for the first nine months of the current fiscal year stand at USD 3.86 billion which is 72% higher than the amount of USD 2.24 billion for the corresponding period of the last fiscal year. Nearly half of these FDI inflows were a result of proceeds from the sale of state enterprises while the financial services sector, telecommunications and the energy sector remained the primary recipients of the bulk of FDI.

Figure 1: Foreign Direct Investment (FY01-FY06)



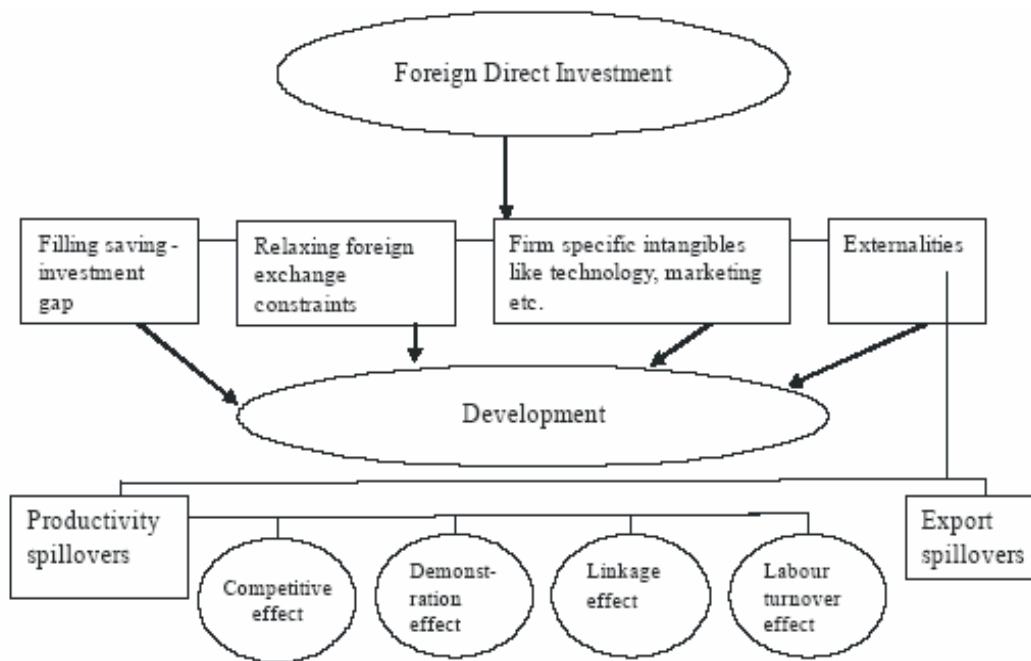
Looking into the Two Way Mirror

“Trade and investment are only a means to an end, not an end in themselves” (Sims & Lake, 2000)

Attraction of FDI is becoming increasingly a global phenomenon often based on the implicit assumption that greater inflows of FDI bring unambiguous benefits to the economy. Like any other flow of capital, FDI represents a source of capital and therefore is believed to contribute positively to Gross Domestic Product, Gross Fixed Capital Formation, and balance of payments. In addition to this, FDI has the potential to generate employment, raise productivity, transfer foreign skills and technology, and subsequently

contribute to the long-term economic development of the world's developing countries. FDI can also contribute toward debt servicing repayments while also stimulating export markets and producing foreign exchange revenue. Subsidiaries of multinational enterprises, which bring the vast portion of FDI, are estimated to produce around a third of total global exports. Figure 2 identifies the following linkages between FDI and economic development.


Figure 2: Linkages between FDI and Development



However the impact of FDI is dependant on what form it takes. This includes the type of FDI, sector, scale, duration and location of business and secondary impacts on the economy. Therefore a refocusing of perspective, from merely enhancing the availability of FDI, to the better application of FDI for sustainable objectives is crucial to reap the real benefits of FDI. Economic literature has outlined a range of positive and negative aspects of FDI as a source of development for developing economies which we will highlight in this section.

Social Development: for All or for Few?

FDI, where it generates and expands businesses, helps stimulate employment, raise wages and replace declining market sectors. However, the benefits may only be felt by a small portion of the population, example where employment and training is given to more educated, typically wealthy elites or there is an urban emphasis. As a result wage



differentials between income groups will be exacerbated. Cultural and social impacts may also occur when investment is particularly directed at non traditional goods. For example, if financial resources are diverted away from food and subsistence production towards more sophisticated products, a culture of consumerism may develop and there may be negative environmental impacts.

Increasing Money Supply

Huge foreign currency inflows resulting from increased FDI under a flexible exchange rate regime where exchange rate is determined by market forces essentially result in appreciation of the local currency. For example in case of Pakistan, excess dollar inflows will increase the supply of dollar in the market, exerting a downward/upward pressure on the dollar/rupee. This shall reduce the burden of foreign debt and is therefore beneficial in debt repayments.


However economies where exchange rate is rather actively managed by their central banks, FDI inflows can result in increased money supply. For example, in Pakistan the SBP manages the rupee dollar parity closely, allowing it to fluctuate only within a narrow band. This essentially means that SBP has to absorb any additional supply of dollars resulting from FDI which otherwise will result in appreciation of the rupee. The SBP therefore moves to buy these dollars, in turn increasing the level of its foreign exchange reserves. Though these reserves present a constructive balance of payments outlook in the short to medium term, making it a more than welcome development, it presents a challenge to the monetary management. This is because SBP's purchase of dollars, in an attempt to prevent the rupee from appreciating, inevitably results in an increase in money supply as it buys dollar in exchange for the Pakistani rupee which it essentially has to create.¹

Is Knowledge necessarily Contagious?

According to economic theory, FDI inflows stimulate economic growth primarily through *efficiency spillovers* that are generated in the recipient economies. Often known as the contagion effect, knowledge is diffused to local firms and workers, raising the efficiency, productivity and marketing skills of domestic firms. While knowledge diffusion is postulated for multinational enterprise investment in both developed and developing economies, it is the transfer from industrialized to developing economies that promises the greatest hope for global economic development.

Efficiency spillovers can occur through several routes, including the copying of multinational enterprise technology and management practices by local firms and the

¹ The monetary impact of foreign inflows in Pakistan has been discussed in detail in Issue 34: Heads We Loose, Tails We Loose Again.




training of workers who then find employment in local firms or start their own. The most important conduit, however, is the linkage between foreign firm affiliates and their local suppliers. These firms help prospective suppliers set up production facilities and often provide them with training in business management as well as in product innovation to enable them to meet the high quality standards of the foreign firms. In this way transfer of technology and managerial know-how improves productive capacity while expanding business opportunities for the host economy. FDI also increases competitive pressures to the local firms that result in an improvement in technical and allocative efficiency in the host country.

However empirical evidence regarding existence of efficiency spillovers in developing economies is mixed. Some studies have found clear evidence of spillover effects, while others have found limited or even negative effects. The evidence gathered of most empirical studies suggests that there is no automatic or consistent relationship between FDI and efficiency spillovers, either for developing countries as a whole or for all industries within a county. Hence FDI may or may not generate spillovers. What is rather clear is that FDI generates efficiency spillovers in presence of conducive policy and institutional and market environments. Again there is little consensus on what constitutes a conducive policy. Most analysts argue that a liberal trade and investment regime which allows multinational firms maximum flexibility has the best chance of increasing the efficiency of local firms and integrating them into global supply chains while some conclude that the most important ingredient in capturing spillovers and indeed, in increasing productive capacity is the presence of a strong state acting to nurture domestic firms through effective, market friendly and performance related subsidies.

Crowding In or Crowding Out Domestic Investment?

FDI is valued particularly for the bundle of assets that multinational enterprises deploy with their investments. These assets are often scarce in developing economies like Pakistan; they include technology, management skills, channels for marketing products internationally, product design, quality characteristics, brand names, etc. In evaluating the impact of FDI on development, however, a key question is whether these multinational enterprises crowd in domestic investments or whether they have the opposite effect of displacing domestic producers or obstructing their investment opportunities.

This is a rather important question. In recent theoretical and empirical work in economic literature, investment has been identified as a key variable for determining economic growth. Thus, if FDI crowds out domestic investment or fails to contribute to capital formation, it would be reasonable to question its benefits for the recipient developing economies. Moreover, given the scarcity of domestic entrepreneurship and the need to nurture existing entrepreneurial talent, the possibility of foreign investment displacing domestic investment would also cast doubts on the favorable development effects of FDI.




These are all the more important questions in the case of our economy when we consider the fact that our FDI inflows are huge in magnitude. FDI, as a share of total gross fixed capital formation is growing significantly for the past six years and this is the case in most developing economies. In fact, FDI is a much larger proportion of investment in developing than in developed economies.

Most economists argue that FDI necessarily stimulates domestic investment through technology spillovers which increase the productivity and efficiency of local firms. Nevertheless the *crowding in* effect of FDI on investment may be gained whether or not there are technology spillovers or even if much value beyond labor is added in local production. Assembly operations, for example, where workers put together components made elsewhere can still drive domestic investment and growth via increases in local consumer demand.

However it is crucial to explore the other possibility that may result from huge FDI inflows – *crowding out* of domestic investment. Foreign investment may undermine local savings and *crowd out* domestic investment by competing in product, service and financial markets and displacing local firms. While FDI is similar to import competition with respect to product market competition, the entry of foreign firms generates however an additional effect on domestic entrepreneurship since these firms also crowd out domestic firms on the labor market. This crowding out effect does not only result in a lower number of domestic entrepreneurs but also gives rise to a situation where the best entrepreneurs may become workers in the affiliates of foreign based multinational enterprises. Since firm specific advantages transferable across borders enable multinational enterprises to compete successfully in foreign countries with a better production technology compared to local firms, the correspondingly higher wages paid by foreign firms skim the domestic labor market and decrease the labor supply for domestic companies at least in the short term.

As a result, the inflow of FDI which essentially entails new competition and the transfer of capital and technology exogenous to the conditions prevailing in the domestic market, changes the number of domestic firms in an economy. The loss of domestic firms can undermine market competition, leading to inflated prices and lower quality products.

FDI can also crowd out domestic investment by borrowing in domestic capital markets, thus driving up interest rates and cost of capital to business. High domestic interest rates may also be the result of deliberate government policies to attract foreign capital. The higher than global average interest rates will also cause the exchange rate to be overvalued, further crowding out domestic firms producing for export. While foreign firms will also suffer from loss of competitiveness, the impact is cushioned by their access to foreign sources of financing. While much is made of the potential for FDI to increase foreign exchange earnings, there is a risk that it will instead contribute to crises



in the balance of payments by repatriating profits and by increasing the rate of imports faster than the rate of exports.

Hence the biggest risk is that FDI could lead to an overall contraction, rather than an increase, in domestic investment and subsequently economic growth. Indeed, the possibility that FDI might lead to fundamental economic distortion and pervasive damage to the development prospects of the country is ever present.

Which Side of the Coin are we playing?

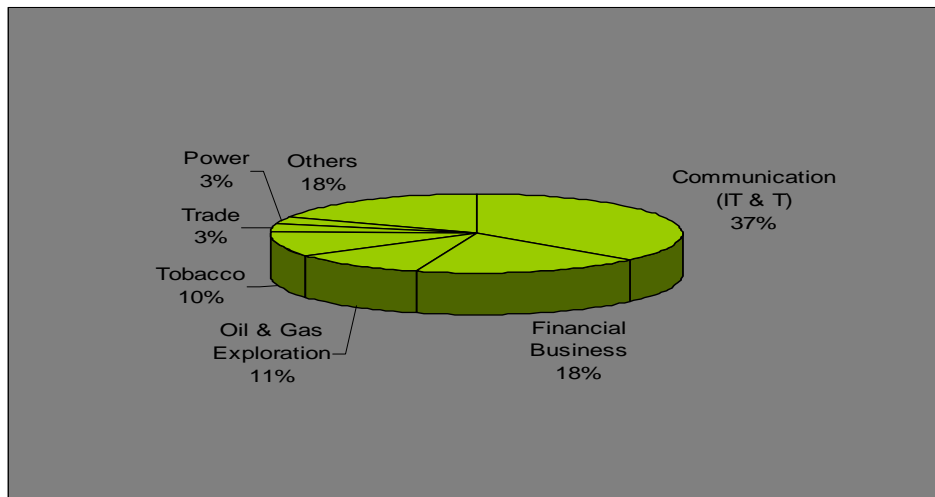
As mentioned in the beginning of the report, the FDI inflows in Pakistan, strongly influenced by rapid liberalization of financial markets and privatization of economic activity, have registered significant growth in the past few years. The FDI inflows for Jul-Mar 2007 period stand at USD 3.9 billion and are expected to go beyond the USD 6 billion mark by the end of the year.

After exploring the pros and cons of FDI in the light of empirical evidence present in economic literature, it is clear that FDI is after all not a miracle drug for all developing economies as it was thought of in the 1990s. This raises some serious questions regarding the rapidly rising FDI inflows in Pakistan.

What is interesting or rather fortunate to note is that currently Pakistan is bent more towards reaping the favorable side of the FDI inflows. Though increased foreign inflows in the recent months have expanded the reserve money growth, the benefits of these inflows cannot be ignored.

Figure 3 gives the classification of the FDI inflows in terms of different sectors of the economy for the first nine months of the current fiscal year. The communications sector and the financial business sector, being the major recipients of FDI inflows have contributed significantly towards the economy's GDP. This is because investment in electronics and other high-tech industries is widely seen positively in developing countries like Pakistan, providing employment opportunities, and boosting exports by increasing production and in modernizing the economy. However the manufacturing sector, especially the textile sector, has received meager FDI inflows. This means that Pakistan has received little export oriented FDI, limiting the role of FDI as a tool of export promotion. Besides these sectors, in other sectors, many foreign companies including Nestle, Unilever and Procter & Gamble are expanding their infrastructure in the country.

Figure 3: FDI (Jul-Mar FY07) by Leading Sectors



Taking the presence of Nestle in Pakistan as a case-in-point, the success of FDI in the economic well being of the country is all the more obvious. Nestle Pakistan Limited formerly known as Nestle Milkpak Limited came into limelight with its product, Milkpak. The Group's principal activities involve manufacturing, processing and selling food products and ancillary equipment. The food products include dairy, confectionery and culinary products, coffee and beverage and drinking water.

With the introduction of their most celebrated product - tetra pack UHT milk, Milkpak, Nestle introduced the milk collection system where milk is directly collected off the farms. This drastically improved the face of livestock. As a result the milk processing industry has shown a growing trend and dairy plants have been established in various parts of the country. What is appreciable is the Group's role in product pioneering. Since the introduction of Milkpak and later fresh fruit juices and yogurts, many local firms have come forward with development of similar products. Hence Nestle has triggered a constant emergence of large, medium and small food processing enterprises that are set to meet the growing demand for milk, fruit juice and fruit juice beverage. The development of new technologies and improved management practices by Nestle has undoubtedly generated efficiency spillovers as reflected by the changing landscape of the dairy products and beverages (juices) industry. Moreover, Nestle products contribute significantly towards the economy's exports. Hence taking the case of Nestle, it is obvious that FDI has rather crowded in domestic investment while the expanding infrastructure of Nestle continues to generate employment in the country and stimulate domestic investment in similar industries.



Heads: We Win!

Observing the current impacts of FDI on the economy, particularly in terms of efficiency spillovers generated by multinational corporations, it is reasonable to take FDI in Pakistan as an important vehicle for economic growth. The government has successfully introduced a wide range of incentives, congenial for local and foreign investors and has increasingly tended to turn to FDI as a source of capital, technology, managerial skills and market access needed for sustained economic development.

The outward orientation in policies designed by the government to attract more FDI has been accompanied by the adoption of policies relating to privatization and deregulation of economic activity, offering unprecedented and conducive business environment to all multinational corporations. Hence Pakistan is now stands out as one of those economies in the region whose reforms and economic achievements during the last few years have steered the country to a business-friendly environment, creating a win-win situation for both investors and consumers.



Economic Snapshot

Fiscal year 06-07

	Units	March	April	May	June	July	Aug	Sep	Oct	Nov	Dec	Jan	Feb	March
<u>Inflation</u>														
Headline Inflation	%	6.91	6.16	7.12	7.65	7.63	8.93	8.73	8.11	8.07	8.88	6.64	7.39	7.67
Core inflation	%	6.67	6.43	6.58	6.29	6.28	6.20	6.16	5.70	5.62	5.5	5.3	5.72	5.42
Food inflation	%	5.42	3.64	5.59	7.78	7.44	11.08	11.26	10.54	10.62	12.71	8.7	9.99	10.74
Non-food inflation	%	7.98	8.01	8.21	7.55	7.77	7.43	6.98	6.41	6.27	6.22	5.2	5.59	5.54
<u>T-bill (Wgt Avg)</u>														
3 month	%	8.10	8.10	8.10	8.29	8.32	8.63	8.64	8.64	8.65	8.64	8.64	8.64	8.65
6 month	%	8.29	8.29	8.29	8.45	8.49	8.81	8.81	8.81	8.81	8.81	8.81	8.81	8.82
12 month	%	8.79	8.79	8.79	8.79	8.79	9.00	9.00	9.00	9.00	9.00	9.00	9.01	9.01
<u>External Sector</u>														
Export	Mln US\$	1,536	1,450	1,527	1,533	1334	1392	1392	1288	1448	1536	1227	1421	n.a
Import	Mln US\$	2,269	1,656	2,330	2,685	2383	2267	2172	2162	2139	2365	2100	2103	n.a
Trade balance	Mln US\$	(733)	(206)	(803)	(1152)	(1049)	(875)	(780)	(874)	(691)	(829)	(873)	(682)	n.a
<u>Remittances</u>	Mln US\$	444	401	507	464	376	435	422	410	448	475	391	457	520
<u>Forex Reserves</u>	Mln US\$	12,487	13,021	13,003	13,137	12,725	12,631	12,512	12,503	12,460	12,960	13,212	13,378	13,624
n.a = Not Available														



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