



27-28 March 2008

# GLOBAL FORUM VII

ON International Investment

## TRADE AND INVESTMENT LINKAGES AND POLICY COORDINATION: LESSONS FROM CASE STUDIES IN ASIAN DEVELOPING COUNTRIES

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### Session 1.2 : Trade policy

This paper was submitted in response to a call for papers conducted by the organisers of the OECD Global Forum on International Investment. It is distributed as part of the official conference documentation and serves as background material for the relevant sessions in the programme. The views and opinions presented here are those of the author and should not be viewed as necessarily reflecting those of the United Nations or any ARTNeT members or partners.



## **Trade and Investment Linkages and Policy Coordination: Lessons from Case Studies in Asian Developing Countries\***

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Asia has undoubtedly benefited greatly from globalization, with many countries of the region relying to a significant extent on international trade and investment as their main engine for economic growth and development. As the economies of the region continue to grow at the fastest pace of any other regions in the world, however, some have begun to question how well the gains are shared within the countries themselves. Indeed, there is some evidence that higher economic growth has led to increases in inequality in the countries of the region. This in turn has led to the realization that trade, investment and related domestic policies, which are de facto developed and implemented independently by various government bodies, need to be made more coherent if one is to achieve a more sustainable and inclusive growth, as well to maintain a country or a region's competitiveness in the global economy.

In that context, the Asia-Pacific Research and Training Network on Trade (ARTNeT)<sup>1</sup> launched an exploratory study on trade and investment policy linkages and coordination in 2007<sup>2</sup>, which included exploratory surveys of private sector stakeholders in three South-Asian countries (Bangladesh, Nepal and Sri Lanka) on the need for improved trade and investment policy coordination and coherence based on the Policy Framework for Investment (PFI) developed by OECD. Following a short overview of trade and investment linkages from an Asian perspective, this paper summarizes the key findings from the exploratory surveys.

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<sup>1</sup> ARTNeT is a network of policy research institutions in developing countries of Asia and the Pacific, with the Secretariat provided by UN-ESCAP and financial support provided by IDRC, Canada, WTO, UNDP and other core partners. See [www.artnetontrade.org](http://www.artnetontrade.org) for details.

<sup>2</sup> Some of the papers undertaken as part of the regional study are available in ESCAP (2007).

## Trade and investment Linkages and Coordination: Some evidence from Asia

The link between trade and investment, particularly foreign direct investment, has been extensively discussed in the literature. FDI can be a substitute for trade, e.g., when a firm decides to invest and produce in a foreign country to serve customers in that country. FDI can also be a complement to trade as efficiency-seeking firms look for the best location from which to produce and export their products.

**Table 1 - Summary of bilateral trade and investment relationships**

	<b>Effect of FDI inflow (FDI<sub>ij</sub>) on Trade</b>	<b>Effect of trade on FDI inflow (FDI<sub>ij</sub>)</b>
Total trade between home and host country	++	+++
Exports from home to host country (EX <sub>ij</sub> )	+	+++
Exports from host to home country (EX <sub>ji</sub> )	+	+
Imports of home from host (IM <sub>ij</sub> )	++	++
Imports of host from home country (IM <sub>ji</sub> )	++	+++
Exports from home country to ROW (EX <sub>io</sub> )	-	++
Exports of host country to ROW (EX <sub>jo</sub> )	--	+
Imports of home country from ROW (IM <sub>io</sub> )	+	+++
Imports of host country from ROW (IM <sub>jo</sub> )	+	++

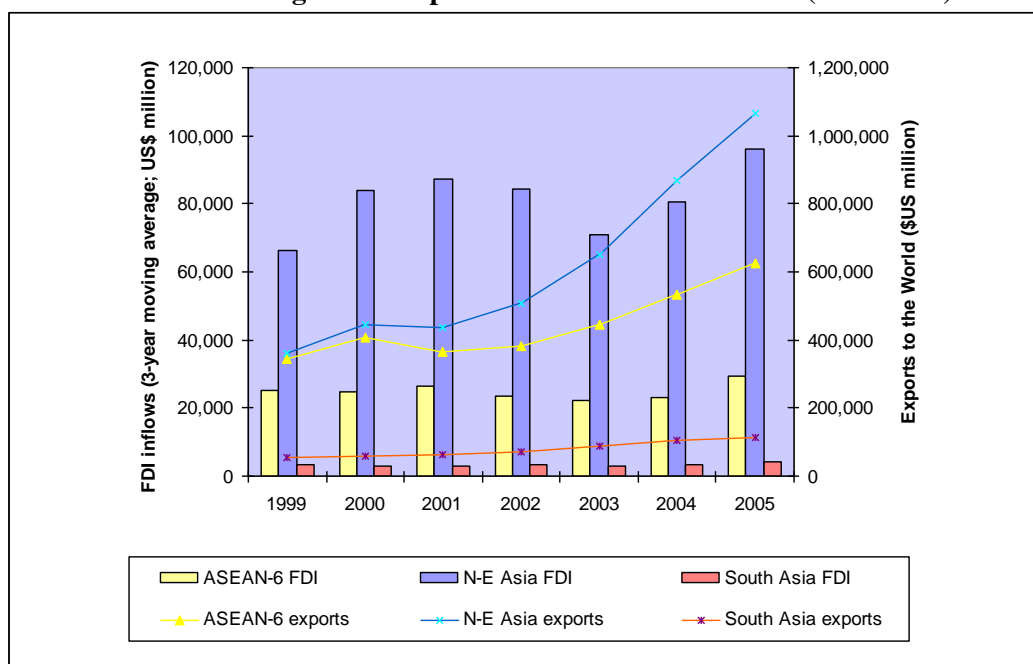
Note: + and – signs represent the directions of the effect; the number of + or - signs for each relationship indicates the strength of the effect. ROW: rest of the world

Source: Chaisrisawatsuk et al. (2007)

As trade barriers have fallen over the past two decades in most parts of the world and as intra-firm trade between countries have increased, a strong relationship has been observed between foreign trade and investment flows, including in Asia. For example, an ARTNeT study by Chaisrisawatsuk et al. (2007), studying the linkages between trade and FDI flows of ASEAN and OECD countries<sup>3</sup>, finds strong positive and self-reinforcing relationships between bilateral trade and FDI flows, with trade inducing FDI as well as FDI inducing trade – the latter to a lesser extent, however (see table 1).

<sup>3</sup> Dataset included OECD and ASEAN-6 countries bilateral trade flows and bilateral FDI inflows from 1980-2004

**Figure 1 - Exports and FDI inflows in Asia (1999-2005)**



Source: calculated by the author; data compiled from WITS, ITC trade-map and investment-map.

Notes: (1) N-E Asia: North East Asia flows include only China, Hong-Kong, China Rep. of Korea, and Mongolia export and FDI flows;

(2) South Asia includes Bangladesh, Bhutan, India, Nepal, Pakistan and Sri Lanka

Figure 1 illustrates this positive link between trade and investment flows in Asia, where sub-regions that exports most are also the ones where foreign direct investment flows are highest<sup>4</sup>. Interestingly, although the South Asian grouping includes the fast growing economy of India, manufacturing exports from that region remain small compared to those of other Asian sub-regions. The figure also suggests that exports of Southeast Asian countries might not be keeping up with those of East Asia, particularly those of China.

At the regional level, the realization that trade, investment and other economic policies were inextricably interlinked has led governments in the region to re-think the way economic cooperation agreements were negotiated. The tendency is now to negotiate broader economic cooperation agreements and the many bilateral preferential trade agreements that have flourished in recent years in Asia now include investment provisions (see, e.g., Kumar, 2007; Sauve, 2007).

At the national level, although some form of overall economic policy coordination mechanisms are in place in all countries, the extent to which trade and investment policies are actually coordinated, and the extent to which they are developed through inclusive consultations, often remain unclear. Information obtained from Asian ESCAP member countries during an ARTNeT Consultative Meeting held in July 2007 show that the institutional mechanisms vary greatly from country to country. Four of the eleven developing countries who provided inputs - for example, Malaysia - appear to have one reportedly have one ministry or department responsible for both trade and investment policy issues, while others - for example, Thailand - deal with trade and investment through two distinct institutions.

<sup>4</sup> The figure also suggests that FDI lags exports by one to 2 years – e.g., the slowdown in export in 2001 seem to correspond to a slowdown in FDI inflows in 2003-, although this would need to be confirmed by a more rigorous analysis

All countries readily recognized the need for extensive consultations among ministries and agencies, as well as the private sector, in order to develop appropriate trade and investment policies. While little detail is available on the consultation processes in place in each country at this stage, it appears that consultations in some countries take place only at a relatively high level, thus possibly excluding relevant but less organized stakeholder groups in the discussion, such as small businesses, local governments, as well as unaware line ministries. In addition, consultations with the private sector appears to take place through chambers of commerce and business associations, implicitly assuming that those organizations are truly representative of the needs of the private sector, which may not always be the case. Finally, involvement of non-government stakeholders other than from the business sector seems limited in most of the countries, although experts from academia seem to be involved in some of the apex policy planning bodies.

### **Business perceptions on trade and investment policy coherence in Bangladesh, Nepal and Sri Lanka**

Small scale perception surveys were conducted among investors, importers and exporters in all three countries. The design of the initial survey instrument was inspired from the OECD Policy Framework for Investment (PFI), as this framework was thought to provide an appropriate basis for the development of more comprehensive and integrated trade and investment policy frameworks in countries of the region. The pilot survey/interview instrument is provided in the Annex.

#### **On the importance of trade relative to other policies for investment**

One important objective of the exploratory surveys was to identify the importance of policies other than investment policies and related investment promotion activities on investment. The results suggest that both trade and tax policies play a crucial role in influencing investor's decision to continue to invest (see table 2). Infrastructure and financial sector development as well as public governance are also perceived as very important by investors, followed by human resource development policies. In contrast, competition policies, corporate governance policies and responsible business conduct policies are ranked as relatively less important investment-related policies by investors in the three countries. Those results are broadly consistent with expectation, as the last three sets of policies may generally be seen as likely to reduce the freedom of investors.

**Table 2- Importance of selected policies for investors in three South Asian countries**

<b>Policies</b>	<b>BANGLA DESH</b>	<b>NEPAL</b>	<b>SRI LANKA</b>	<b>Overall Rank</b>
<b>Trade Policy</b>	1	1	2	1
<b>Tax Policy</b>	2	2	1	2
<b>Infrastructure and Financial Sector Development</b>	2	3	4	3
<b>Public Governance</b>	4	4	2	3
<b>Human Resource Development Policies</b>	4	4	4	5
<b>Competition Policy</b>	7	8	4	6
<b>Corporate Governance Policy</b>	7	4	7	6
<b>Responsible Business Conduct Policies</b>	4	7	8	6

Source: ARTNeT pilot surveys conducted by IPS, CPD and IPRAD, 2007

The difference in importance between the first four policy areas that may affect investors is not large, suggesting that investors on average value an integrated and balanced approach to the development of a favorable investment environment. This result points to the need for regular assessment of the various policy areas from the investor point of view to monitor which may be becoming the “weakest link” for investment.

The results of the exploratory survey also suggest that the priority and importance of various components of a holistic/comprehensive policy framework are likely to vary substantially across stakeholder groups, including among investors themselves. For example, results from Bangladesh indicate that foreign investors put the same emphasis on trade and tax policies, while domestic investors emphasized mainly trade policy. Non-exporting domestic producers also stressed the importance of tax policy relative to trade policy, in contrast to exporters. Interestingly, multi-national corporations seemed to perceive all policy areas as equally important, while other private stakeholders’ ranking of the importance of policies varied much more substantially – the absolute ranking in importance of the policies remained similar, however.

The regular assessment of the various policy areas within an agreed comprehensive trade and investment policy frameworks, as suggested above, would therefore need to involve a balanced representations from the various investors (e.g., based on size and export orientation), as well as from consumer and other stakeholder groups (which are likely to emphasize competition policies and corporate governance)<sup>5</sup>.

### **On the complementarity between trade and investment policies**

The perception of the business sector stakeholders interviewed support the idea of complementarity between trade and investment, with 92% of Sri Lankan respondents, 88% of Bangladeshi respondents and 80% of Nepalese respondents agreeing that “policies relating to trade in goods and services can support more and better quality investment by expanding opportunities to reap scale economies and by facilitating integration into global supply chains, boosting productivity and rates of return on investment”.<sup>6</sup> The perception of the business sector is consistent with findings based on econometric analysis. The differences in perception across the three countries may provide an indication of the business sector’s readiness for further liberalization.

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<sup>5</sup> It may be worth noting in that context, that it is unlikely that any government agencies could conduct this assessment in an unbiased manner, and that it may therefore be more appropriate to leave these assessments to independent research institutions to the extent possible.

<sup>6</sup> Chapter 3, OECD Policy Framework for Investment.

## On Businesses' satisfaction with trade policy measures for investment

While business sector stakeholders overwhelmingly recognize the importance of the trade and investment link, they generally indicate that they are only “somewhat satisfied” with trade policies and measures taken by their governments and which may affect investment.

**Table 3 - Investors' satisfaction with trade related policies and measures**

Private sector satisfaction with:	BANGLAD ESH	NEPAL	SRI LANKA	Average
The mechanisms in place to consult investors and other interested parties on planned changes to trade policy	2.2	2.0	1.9	2.0
The level of trade policy and regulatory certainty and predictability	1.9	2.4	2.0	2.1
The customs, regulatory and administrative procedures at the border and related compliance costs	1.8	2.1	2.4	2.1
The Government efforts to enter into market-expanding international trade agreements (including implementation of WTO commitments)	2.1	2.1	2.6	2.3
The measures seeking to address weaknesses in sectors of importance to traders (e.g., Gov. support to export finance and import insurance schemes)	2.2	2.3	2.5	2.3
<b>Overall level of satisfaction</b>	<b>2.0</b>	<b>2.2</b>	<b>2.4</b>	<b>2.2</b>
<i>Note: 1=not satisfied; 2=some what satisfied; 3= satisfied; 4= very satisfied; 5= fully satisfied</i>				
Source: ARTNeT pilot surveys conducted by IPS, CPD and IPRAD, 2007				

As shown in table 3, *uncertainty and unpredictability of trade policy and regulations* may be an issue in Bangladesh and Sri Lanka, while the *mechanisms in place to consult investors on planned changes to trade policy* appear to be of most concern in Nepal and Sri Lanka. Among the trade policy/regulatory areas included in the survey, *customs, regulatory and administrative procedures at the border* is the one for which the Nepalese business sector seem to be least satisfied.

Government *efforts to enter into market-expanding international trade agreements* is the area in which the highest level of satisfaction is reached in Sri Lanka. Businesses also seem to be relatively more satisfied with Government measures seeking to support overall trading activities, potentially suggesting that they find that these specific trade support measures (e.g., Government backed trade finance) may not significantly affect investment, as opposed to tackling broader systemic issues.

Stakeholders satisfaction with policies appear to also depend on the sector in which they operate. In particular, companies or representatives of traditional manufacturing sectors appear to be relatively more satisfied than the companies operating in fast growing service sectors. For example, in Sri Lanka, 78% of the services companies in the sample agreed that government tended to be unpredictable and discouraged further investment, while government policy was only seen as a problem by 35% of the textile and clothing manufacturing companies.

## **On prioritizing actions and trade policy measures to improve the overall policy framework for investment**

The priorities identified by the business sectors generally reflect quite directly their levels of satisfaction discussed earlier. The highest priority identified in both Nepal and Bangladesh is to reduce compliance costs of regulatory and administrative procedures. Reducing trade policy uncertainty and consulting investors and other interested also receive high priority.

Priority rankings in Sri Lanka are different, reflecting in part its higher level of economic development. Reducing regulatory compliance costs only comes fourth in terms of policy priority. Increasing trade policy predictability appears to be highest priority, with 90% of the business sector asking for this issue to be tackled as part of a national policy framework on investment. Implementation of trade policy measures that address sectoral weaknesses in the country is also seen as high priority, followed by the need to consult investors on planned trade policy changes.

Interestingly, results in all three countries indicate that “*increasing investment opportunities through market-expanding international trade agreements*” should receive a low priority relative to the other (four) trade policy measures identified in the survey – and the OECD PFI. This result is striking given the time and resources governments in the region have allocated in recent years to the negotiation of trade agreements, particularly and increasingly at the bilateral level.

## Conclusion and implications

Results presented and discussed in this paper should be interpreted with caution as they are mainly based on small scale exploratory pilot surveys in three countries. More extensive and structured data collection efforts would be needed in both the three countries studied, as well as in other countries in Asia, to confirm the results and draw strong policy conclusions for either individual country in the region.

That being said, the three country case studies suggest the following trade-related policy directions to improve trade and investment policy frameworks in developing countries of the region:

- *Reduce uncertainty/increased predictability of trade policy as well as related policies.* This can be achieved by increasing lead time and information provided to stakeholders before a policy change is made and making sure that the policy changes do not occur too frequently. Simplification of trade policies, for example by simplifying tariff schedules, may also be helpful in this regard.
- *Review existing institutional mechanisms in place for trade and investment policy making, and revise them as necessary to ensure more integrated and inclusive trade and investment policies.* The mechanisms should, to the extent possible, engage all relevant stakeholder groups in developing policies regularly and consistently. Efforts to identify individuals and organizations truly representative of the private sector or consumers, seems particularly important. Relying on independent research institutions to identify private sector and consumer interest may be necessary given the difficulty associated with identifying representative samples. In the context of identifying consumers' interest, regional and comparative analysis of consumers' well-being (purchasing power in various sectors) may be highly relevant and could be facilitated by Governments.
- *Allocate resources to strengthening policy implementation and enforcement, as opposed to developing new policies.* For example, as suggested by the results in this study, reducing human and capital resources spent on negotiations of bilateral agreements and increasing resources that go into border trade management and facilitation may be considered in many developing countries in the region.
- *Build capacity and develop institutional mechanisms to regulate emerging or fast growing sectors, particularly in services.* While many governments have significant experience in regulating the agricultural and manufacturing sectors that were gradually opening, many have much less experience dealing with fast growing and sometimes fast-opening national service sectors. Services sectors (e.g., health, transport, finance, and telecommunication) often involve ministries and agencies that have not been routinely or closely involved in international trade and investment policy issues, leading to a lack of coherence and policy predictability in these sectors.
- *Take a holistic, as opposed to a narrow or negotiation's based approach to international trade and investment policy making.* Business representatives surveyed perceived that many non-trade policy and non-investment policy issues affect their ability and willingness to trade and/or invest. Focusing more on developing business facilitation and competitiveness policies - regardless of whether the businesses are domestic or foreign owned – may actually be more effective in increasing trade and generating investment.

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## Annex

### Private Sector Survey Questionnaire (Bangladesh Sample)

*This survey is conducted by The Centre for Policy Dialogue, Dhaka as part of a research study aiming at assessing the need to coordinate trade and investment (particularly FDI) policies to improve the overall investment climate in Bangladesh and the region<sup>7</sup>. The purpose of the survey is to collect the views of private sector stakeholder on this issue, on the basis of which policy recommendations will be formulated. Your answers will remain confidential and survey results will only be reported in aggregate form.*

**1. Your company is (check the one that describes your company most closely):**

- a. a state-owned company**
- b. a private domestic company**
- c. a subsidiary/affiliate/branch of a foreign company**
- d. a joint venture (% of foreign ownership: \_\_\_\_\_)**

**2. Primary sector/industry/Product: \_\_\_\_\_**

**3. Number of employees: \_\_\_\_\_**

**4. On average, what is the import content of the products you manufacture (in % of product value)?**

Less than 20%    20 to 40%    40 to 60%    60 to 80%    More than 80%

**5. On average, how many percent of your production is exported**

Less than 20%    20 to 40%    40 to 60%    60 to 80%    More than 80%

**6. For the purpose of this survey, do you consider yourself as representing (circle all that apply, i.e., you may circle more than one):**

- a. A foreign investor**
- b. A domestic investor**
- c. An exporter**
- d. An importer**
- e. An entire industry**
- f. Other (please specify): \_\_\_\_\_**

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<sup>7</sup> This study is part of a larger regional research effort undertaken by the Asia-Pacific Research and Training Network on Trade (ARTNeT) with the support of the United Nations Economic and Social Commission for Asia and the Pacific (UN ESCAP). For more information, please contact: [artnetontrade@un.org](mailto:artnetontrade@un.org).

**PART I – IMPORTANCE OF SELECTED POLICIES AND ISSUES ON INVESTMENT DECISION**

**A. Many factors affect your company's/ your industry's ability and willingness to invest in COUNTRY. Investment decisions are affected by various policies and issues which go beyond a country's basic investment policy. Please rate the importance you attach to the following policies/issues when making investment decisions (circle the appropriate number: 1= not important, 2=somewhat important, 3=important, 4=very important, 5=most important.**

<b>a. Trade Policy</b> [ <i>Policies relating to import and export of goods and services, such as tariffs, licensing, customs procedure</i> ]	<b>1 2 3 4 5</b>
<b>b. Competition Policy</b> [ <i>Competition policy generally help ensure that companies operate in more competitive markets, as opposed to more monopolistic markets</i> ]	<b>1 2 3 4 5</b>
<b>c. Tax Policy</b> [ <i>The level of the tax burden and the design of tax policy, including the way it is administered, directly influence business costs and returns on investment.</i> ]	<b>1 2 3 4 5</b>
<b>d. Corporate Governance Policies</b> [ <i>The existence of a corporate governance framework that set basic principles for sound corporate governance, possibly leading to reduce cost of capital and better functioning of domestic financial markets</i> ]	<b>1 2 3 4 5</b>
<b>e. Responsible Business Conduct Policies</b> [ <i>Policies that lead to the effective enforcement of laws on environmental protection, labour relations, financial accountability and human rights</i> ]	<b>1 2 3 4 5</b>
<b>f. Public Governance</b> [ <i>Regulatory quality/clarity and public sector integrity –i.e., absence of corruption – are two important elements of public governance</i> ]	<b>1 2 3 4 5</b>
<b>g. Infrastructure and Financial Sector Development</b> [ <i>lack of infrastructure and/or of a stable financial sector may impede the realization of investment</i> ]	<b>1 2 3 4 5</b>
<b>h. Human Resource Development policies</b> [ <i>policies that develop and/or maintain a skilled, adaptable and healthy population</i> ]	<b>1 2 3 4 5</b>
<b>i. Other</b> (please specify): _____	<b>1 2 3 4 5</b>

**B. Of the above listed issues, which stand out as most important? \_\_\_\_\_**  
**Please elaborate:**

**PART II – TRADE AND INVESTMENT POLICY COORDINATION**

A. It has been argued that “policies relating to trade in goods and services can support more and better quality investment by expanding opportunities to reap scale economies and by facilitating integration into global supply chains, boosting productivity and rates of return on investment”. Do you agree with the above statement?

Strongly disagree     disagree     no opinion     agree     strongly agree

B. As an investor (or recipient of investment), to what extent are you satisfied with the following: (circle the appropriate number: 1= not satisfied; 2=somewhat satisfied; 3=satisfied; 4=very satisfied; 5: fully satisfied)

<b>a. The customs, regulatory and administrative procedures at the border and related compliance costs</b>	<b>1 2 3 4 5</b>
<b>b. The level of trade policy and regulatory certainty and predictability</b>	<b>1 2 3 4 5</b>
<b>c. The mechanisms in place to consult investors and other interested parties on planned changes to trade policy</b>	<b>1 2 3 4 5</b>
<b>d. The Government efforts to enter into market-expanding international trade agreements (including implementation of WTO commitments)</b>	<b>1 2 3 4 5</b>
<b>e. The measures seeking to address weaknesses in sectors of importance to traders (e.g., Gov. support to export finance and import insurance schemes in the financial/insurance sectors)</b>	<b>1 2 3 4 5</b>

C. Which of the following actions should be taken by trade policy makers in priority to improve the overall national policy framework for investment? (please rank top three, with “1” as most important of the three top priority action)

Action/measure	Priority Rank
<b>a. To reduce the compliance costs of customs, regulatory and administrative procedures at the border</b>	
<b>b. To reduce trade policy uncertainty by avoiding rapid and unpredictable changes</b>	
<b>c. To consult investors and other interested parties on planned changes to trade policy</b>	
<b>d. To increase investment opportunities through market-expanding international trade agreements (including implementation of WTO commitments)</b>	
<b>e. To implement trade policy measures that address sectoral weaknesses in the country (e.g., Gov. support to export finance and import insurance schemes in the financial/insurance sectors)</b>	

**D. Do you feel existing trade policies in your industry/sector unnecessarily raise the cost of input of goods and services, thereby discouraging further investment in that industry/sector?**

Yes    No

**E. If yes, please provide some specific example of a trade policy or regulatory measure in your sector/industry:**

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**F. Do you feel that the existing Investment Policy in Bangladesh is discouraging for trade?**

Yes    No

**G. If yes, please provide specific example of an investment policy that became an obstacle for trade.**

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**H. Based on your experience, can you illustrate the importance (or/and lack of) coordination between trade and investment policy in your industry/sector, possibly resulting in reduced competitiveness and investment, with a specific example of conflicting policy/regulation/action:**

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**I. From your perspective, how important is harmonization of investment incentives and regulations across countries (e.g., multilaterally or regionally agreed level or cap on tax rebates given to foreign investors)?**

Not important    Somewhat important    Important    Very Important    Don't know

**Please elaborate:**

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**Part III – Recommendations**

**A. List three major areas for improvement in trade policy of Bangladesh.**

1. \_\_\_\_\_
2. \_\_\_\_\_
3. \_\_\_\_\_

**B. List three major areas for improving the existing investment policy of Bangladesh.**

1. \_\_\_\_\_
2. \_\_\_\_\_
3. \_\_\_\_\_