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FOREIGN DIRECT INVESTMENT

PUTTING IT TO WORK IN DEVELOPING COUNTRIES

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PREFACE

Trade and foreign direct investment (FDI), the twin engines of globalization, both have great potential to transform economic structures and relationships in the developing world. But FDI may ultimately have the greater impact. It is not only a source of financing for new production, but also a very effective means for transferring technologies and best practices to firms and workers in developing countries. The result is higher productivity—the key to growth and development. Well aware of these benefits, developing countries now aggressively seek to attract FDI, and to harness the dynamism of FDI projects for economic growth.

The U.S. Agency for International Development (USAID) works directly in many of the technical and institutional areas that involve FDI and which determine its effects: trade liberalization, capital flows and financial market efficiency, economic reform and privatization, entrepreneurship, technology transfer, and workforce development. The Economic Growth Office of the Bureau for Economic Growth, Agriculture, and Trade (EGAT/EG) is helping missions and host-country governments better understand issues related to economic growth and design and implement programs that increase such growth. Accordingly, EGAT/EG offers USAID officers and their public and private sector partners in host countries this Guide to facilitate their collaboration in making FDI work for development.

EXECUTIVE SUMMARY

The most striking change in development finance in the last 15 years has been the dramatic expansion of external private capital flows to the developing world, particularly in the form of foreign direct investment. In 2003, $135 billion in FDI, on a net basis, flowed to developing countries—more than 60 percent of total net resource flows. FDI far exceeded all other sources of resource flows, including other private sources, such as portfolio equity and debt, and official sources, such as loans and grants.

Though FDI is now the most important external source of long-term funds in the developing world, financing development remains first and foremost an issue of domestic investment. FDI as a share of gross fixed capital formation (i.e., total investment) in developing countries as a group has not risen above 15 percent in the past decade, and has been as low as 2 to 3 percent. FDI's full value, however, lies disproportionately in its unique ability to stimulate competition, spur innovation, introduce new technologies and processes, and elevate the skills of workers and managers in developing countries. These positive effects can benefit not only the foreign affiliates directly receiving FDI, but also host-country firms that supply the affiliates, distribute their products, or even compete with them.

WHAT FDI OFFERS TO DEVELOPING COUNTRIES

For developing countries, the motivations for hosting FDI are compelling: economic growth and development. By adding to domestic savings, FDI makes it possible to raise rates of capital accumulation in both physical and human resources. In competitive environments, high-quality FDI projects elevate the rate of return to investment in the economy as a whole. These projects lead to new employment and wages, and this, in turn, creates more jobs and income in progressively wider circles of the economy. The result is increased economic growth.

FDI's greatest contribution to development, however, lies in its unique productivity-enhancing effects, including

- Improved export capacity and increased imports of foreign-invested firms—both of which help local firms integrate into global production networks;
- Technology transfer in production and management processes;
- Training and skill development among workers; and
- Competition and enterprise development.

Realizing FDI's full value for development, however, requires a framework of market-oriented and outward-looking economic policies and institutions—as well as legal and regulatory structures that complement the discipline of open markets and trade.

WHAT INVESTORS SEEK

Foreign direct investment is a business transaction. Foreign investors decide to invest abroad for a variety of reasons. Most often, they are seeking natural resources, markets, production efficiency, strategic assets, or some combination of these.

Access to natural resources has motivated FDI for more than a century. Much of this investment is solely related to the extraction and export of primary commodities in bulk form, although important follow-on investments in the processing, packaging, and transport of natural resource-based products also exist. Access to natural resources may also motivate investment in forest resources, plantation agriculture production, and large-scale fisheries.

Gaining access to local markets has also long motivated investment in the developing world. Today, investors seeking to reach a foreign customer base may choose to invest there, rather than export there, to cut transport costs, meet local preferences, or use production inputs best sourced locally (such as the water used to produce soft drinks). Regional trade agreements have tended to enlarge the "local market" and its attractiveness to foreign investors. And many services are not tradable and must be produced where they are consumed; banks, retailers, transportation service providers, public utilities, or communications services providers have thus invested in foreign affiliates to serve customers abroad.

The pursuit of efficiency has been a significant motivation for FDI since the 1990s. Global production networks now account for much of the world's manufacture of electronics, automobiles, and other equipment and machinery. Developing countries' low-cost, high-productivity labor has been their point of entry into the networks. In recent years, efficiency-seeking FDI in services has grown even more rapidly than in manufacturing. Foreign affiliates now provide export-oriented data processing or call-center operations, inventory management, quality control, accounting, reservations, and personnel services, among others.

When foreign direct investors perceive synergies between their operation and a foreign asset, they are often motivated to acquire it as a strategic asset—be it research and development (R&D) capabilities, specialized management skills and systems, infrastructure, or a brand with market power.

DEVELOPMENT IMPACT VARIES, OFTEN BY INVESTOR MOTIVE

While all forms of FDI can generate capital accumulation, employment, and income growth, not all necessarily increase economic integration, transfer technology, upgrade human capital, or spur competition. Efficiency- and market-seeking FDI are the most likely to do so. For example, efficiency-seeking FDI can raise host-country competitive advantage by introducing new production technologies, product or service requirements, and managerial practices, thereby establishing the host's reputation for quality, reliability, and productivity. When efficiency-seeking manufacturers begin taking root they involve themselves with local suppliers to good effect. Likewise, efficiency-seeking service providers raise the host country's trade competitiveness by cutting the costs of intermediate services that support exporting—banking, insurance, business support services, transport, electricity, and telecommunications.

Market-seeking FDI has the same positive impact, especially in service industries through transfers of "soft" technology (market awareness, customer service expertise, organizational and management skills). Transfer may occur directly through training or indirectly by "demonstration effect." For example, foreign affiliates of

wholesalers and retailers like Carrefour or Wal-Mart have introduced new information management processes, pricing approaches, and marketing and merchandising methods into developing country markets. The resulting competition in local markets persuades local wholesalers and retailers to adopt new methods, improve productivity and efficiency, and train workers. These same effects are evident in tourism and manufacturing. Innovation and improvements in quality, price, and efficiency all ensue—absent trade restrictions, barriers to entry, and favoring of state-owned enterprises.

In contrast, natural resource-seeking FDI has a mixed impact on development. FDI to extract oil and minerals can lead to significant export earnings, but tends to be isolated physically and by sector, yielding minimal additional value for the host country. When such FDI focuses on large-scale agriculture or fisheries, however, it can create new trade flows, opportunities for processing, and linkages with suppliers and local and regional supermarket chains that lead to technology transfer.

DETERMINANTS OF FUTURE FDI FLOWS

Worldwide FDI patterns have shifted markedly over the past 15 years. Developing countries have become increasingly important as a whole, capturing more than one-fourth of FDI inflows in 2003, the most recent year for which information is available. Those inflows, however, are highly concentrated among a few countries. In 2003, nearly two-thirds of inflows to the developing world went to only 10 countries. China received the largest amount of FDI—$54 billion, dwarfing the inflows to the next two top recipients, Mexico and Brazil, which each received about $10 billion.

Another trend is the growing importance of FDI in the service sector, which now attracts most FDI inflows, both globally and in developing countries. Among the latter, FDI in services increased at a faster rate than investment in manufacturing or natural resources in the second half of the 1990s. Services now represent more than half of inward FDI stock in developing countries.

This dramatic growth will continue. The allure of foreign customers will remain powerful, particularly in developing countries that are growing, becoming wealthier, and offering foreign companies the opportunity to invest in and serve their markets. As noted earlier, many services are not easily traded and must be produced and consumed in the same location; these include utilities, finance, construction, hotels and restaurants, retail and wholesale trade, and transportation. Developing countries have increased their share of the global stock of FDI in these service industries in most subsectors. China will present new opportunities for foreign investors in coming years, given its WTO commitments to free most services by the end of 2005; India is also expected to present new opportunities as it liberalizes the services sector.

Services that are tradable, including those made tradable thanks to information technology, consist of business support activities such as accounting, recordkeeping, and R&D, among others. Providers of these services can distribute this work around the world according to the comparative advantages of locations. Thus, service-oriented FDI flows can now be efficiency seeking. Growth in such FDI in services will likely surge, far outpacing the dramatic increases of the 1990s in the manufacturing sector. In the future, FDI inflows will follow the latest and best opportunities for cost-efficiency that foreign destinations can promise. For developing countries, inflows of this FDI will depend on the variables of cost-efficiency: labor skills, infrastructure quality, political and economic stability, and regulatory effectiveness.

Manufacturing will continue to attract FDI to developing countries, but will be less dynamic than in recent years. Performance over the last 15 years shows a mixed record at the subsector and industry levels, with developing countries increasing their share of world inward FDI stock

in some industries but losing ground in others. In other words, developing countries do not have an across-the-board advantage in attracting FDI to manufacturing.

In many mature industries, production is increasingly technology-intensive, with capital and knowledge assets replacing labor. In a modern automobile plant, for example, a few workers monitor a highly automated production process while others are engaged in purchasing, inventory, logistics, and finance. With much manufacturing actually involving service activities, the appeal of low-cost labor in developing countries is diminishing. This has implications for developing countries. As countries cost themselves out of simpler, lower-tech manufacturing, they will move up to more sophisticated, knowledge- and capital-based activities, leaving the former to other FDI destinations that are still cost-effective. Lower-tech manufacturing opportunities will dwindle as high-tech opportunities increase, giving countries an incentive to climb the ladder and attract technology-based manufacturing FDI. Host countries will need to develop packages of skills, costs, institutions, and policies to compete at all levels of the "ladder" for manufacturing FDI.

Three other significant factors will influence future patterns in FDI: the elimination of global textile quotas that have for many years distorted investment flows, the enduring appeal of China as a destination for foreign investment, and the increase in flows of investment from developing countries like China and South Africa to other developing countries, known as "South–South" investment.

COMPETING FOR AND ATTRACTING FDI

Competition for FDI is intense. More than 400 investment promotion agencies (IPAs) now compete to attract foreign investment. An investor's decision will ultimately reflect an array of variables, including market size, projected growth, existing or prospective linkages to other markets through regional trade agreements, the availability of labor at wage rates commensurate with productivity, the availability of other production inputs, the existence of certain natural resources, and so on. But the multinational investor also pays close attention to political, institutional, and regulatory characteristics that comprise a host country's investment climate. A sound climate figures just as heavily in domestic investors' decisions to establish or expand their businesses.

The investment climate is composed of three elements:

- ***Macroeconomic stability.*** This is a function of reforms that establish competitive exchange rates and market-determined interest rates; fiscal discipline; efficient tax systems and prudent public expenditure and debt management; privatization; deregulation; and property rights; as well as liberalized trade and investment policy environments.
- ***The business-enabling environment.*** This consists of microeconomic factors that affect the way individuals or firms operate in the macroeconomic environment. A positive enabling environment includes good governance (property rights, transparency, rule of law), openness to trade, and minimal distortions (administrative barriers/red tape).
- ***Infrastructure.*** Key variables include physical infrastructure (power, water, transport, communication) as well as technological infrastructure (information and communications technology).

In improving the investment climate, governments tend to concentrate on

- Lowering the costs, risks, and barriers to competition through microeconomic reforms related to, for example, taxes, property rights, and approval procedures;
- Introducing or upgrading special investment regimes (e.g., export-processing zones, investment tax incentives) to establish an

attractive sub-climate within the economy for FDI-based firms alone; and

- Entering into international or regional trade or investment accords that can enlarge their market, and harmonize and/or liberalize trade and investment rules and standards with trading partners.

Although a sound investment climate is nearly always a prerequisite for attracting FDI, most countries also market themselves as efficient and business-friendly host destinations. In the last 20 years, IPAs have become central to the effort of developing countries (and many developed ones) to attract FDI. IPAs generate FDI prospects through marketing and investor targeting, facilitating the realization of investment projects, and providing after-care service of investors. They often work with both foreign and domestic investors. Because of their knowledge of business conditions, IPAs are increasingly involved in advocating policies to improve the business environment. Two important determinants of IPA success are the strength and visibility of the relationship between the IPA and the highest offices of government, and participation of the local private sector in IPA activities through the board of directors.

Several international and regional institutions facilitate and support FDI flows to foster economic development. They provide training and technical assistance related to implementing multilateral investment agreements, and strengthening of FDI promotion skills and institutions. These include the World Bank's Multilateral Investment Guarantee Agency (MIGA) and the World Association of Investment Promotion Agencies (WAIPA). Other international institutions provide risk mitigation instruments and related services and information. These include such bilateral organizations as the U.S. Overseas Private Investment Corporation (OPIC) and its UK, French, and Canadian counterparts.

MAKING THE MOST OF FDI: USAID'S STRATEGIC ROLE

USAID assistance in promoting FDI must be consistent with U.S. legislation, as well internal agency guidelines. USAID officers need to consult these guidelines as they develop new programs or projects to support FDI in developing countries.

Within those parameters, USAID should assist only countries that have clearly demonstrated the political will to tackle fundamental investment climate and other economic reforms as USAID sees them. USAID should then narrow the range of countries that could receive assistance on the basis of careful country-by-country analysis, rather than pre-set geographical or regional criteria.

Some in the aid community believe that scarce funds are spent most productively in countries that have some inherent ability to attract FDI (e.g., because of large-scale domestic markets or resource bases). Others favor dedicating funds to the neediest countries, such as those in sub-Saharan Africa or those that may no longer be able to attract investment because of the end of the global quota regime on textiles and apparel.

USAID should be ready to provide assistance in a variety of sectors—services, manufacturing, and natural resources—and not rely on predetermined ranking of assistance by sector or industry. Assistance can be most helpful if it focuses on one or more of the following activities:

- ***Improving the business-enabling environment*** to benefit both foreign affiliates and domestic firms;
- ***Forging better and stronger supply links*** between FDI-based foreign affiliates and local industries and service providers;
- ***Promoting private provision of infrastructure*** to encourage greater reliability and cost-effectiveness in infrastructure services;
- ***Rationalizing FDI incentive packages*** to assist host countries in identifying, measuring, and

weighing the net benefits and costs of such incentives, thus curbing the wholesale use of incentives and the distortions they introduce into an economy;

- ***Strengthening IPAs*** so they become more effective in general, and better able to implement best practices, as well as to monitor and evaluate their results;
- ***Building capacity to negotiate international, regional, or bilateral investment accords*** to help stimulate and facilitate investment.

For each of these activities, USAID assistance may take many different forms, reflecting the needs of recipient countries. Specific functional approaches may include

- ***Benchmarking*** to help governments and business communities evaluate deficiencies that could productively be remedied, and ways of assessing progress;
- ***Program design*** to establish and rank objectives, develop work plans, and assess progress in any of the activities listed above;
- ***Institutional development*** to make the processes, systems, and procedures of host-country organizations involved in FDI more efficient;
- ***Consensus-building and public–private dialogue*** to ensure a better match between reform needs and government actions;
- ***Evaluation*** to focus donors and host-country partners on priority activities and to measure success or failure relative to the cost of interventions; and
- ***Knowledge management*** to assemble, digest, and organize information on all dimensions of attracting FDI and leveraging its benefits. This could and should result in best-practice models and toolkits for priority assistance functions in each technical area.

Thanks to globalization, foreign direct investment has the potential to transform the lives of people in many more countries than ever before. USAID and other donors can do much to help poor countries use foreign direct investment to spur economic development.

I. INTRODUCTION

More than 900,000 foreign affiliates of at least 61,000 multinational corporations generate an estimated one-tenth of global GDP and one-third of global exports—and their share of world economic activity is increasing.[1] These foreign affiliate firms represent foreign direct investment (FDI) in action. Such firms are important throughout our global economy, but especially in developing countries, where they boost productivity, raise incomes, create jobs, and drive structural transformation. As an economic force in the developing world, FDI deserves the attention of policymakers, business persons, and development practitioners alike.

OBJECTIVE AND OVERVIEW

Sponsored by the U.S. Agency for International Development (USAID), this Resource Guide represents the Agency's recognition of the significance of FDI in developing countries. By explaining the nature and effects of FDI, the Guide is meant to serve as a basic reference tool for USAID officers and their developing country counterparts as they design, implement, and evaluate programs, projects, and policies that build on FDI's potential. For this reason, the Guide's special concern is FDI's relevance for development: while much of the Guide's treatment of FDI's past trends and future directions, benefits, and institutional arrangements is pertinent to world economic growth issues generally, the implications of FDI for the developing world are of central interest here.

Structurally, the Guide is organized to be a ready resource on various aspects of FDI. Chapter 2 explores FDI's development advantages, including its ability to spur productivity, beginning with an examination of foreign direct investors' motives for investing. Chapter 3 presents trends in FDI flows since 1990 and patterns of flows by regional destination and by country income level. Building on this information, Chapter 4 offers insights on the likely future of FDI, including analysis of what will drive investment in services and manufacturing. In reviewing current thinking on best practices for attracting FDI, Chapter 5 addresses the importance of the investment climate and the utility of incentives, as well as the role of investment promotion agencies. Chapter 6 describes the international institutional framework for FDI and analyzes mechanisms that govern FDI flows, examining in particular bilateral investment treaties and regional trade and investment agreements that can support and encourage FDI. Chapter 7 presents possible strategic assistance priorities for USAID and other donor organizations as they help to maximize FDI impacts in developing countries.

The appendixes provide reference material. Appendix A presents detailed data tables on FDI flows and stocks; Appendix B is a bibliography of investment-related publications and other resources, including Internet addresses; and Appendix C is a glossary of terms related to FDI.

FOREIGN DIRECT INVESTMENT AND THE DEVELOPMENT MODEL

Economists agree that economic growth drives development. They do not fully agree on what drives growth. Some—the "capital fundamentalists"—assert that capital accumulation, through investment in plant, equipment, and worker training and general education, is most important in raising total output and output per worker. Others emphasize the role of "total factor productivity," a difficult-to-measure bundle of positive variables including technology, organizational methods, and institutions that affects how well firms and societies can respond to economic opportunities and incentives.[2]

Regardless of their positions in this debate, all parties would probably still agree on the importance of FDI, for two reasons. First, FDI has become the dominant and most reliable external source of investment capital for the developing world. And second, FDI delivers this investment capital in a way that enhances total factor productivity.

EXTERNAL CAPITAL FLOWS

One of the most striking changes in international finance over the last 15 years is the vigorous expansion of external private capital flows to the developing world. In 1990 all net external capital supplied to developing countries totaled about $110 billion, made up in equal parts of net private flows and net official flows (loans and grants). By 2003 total net resource flows had doubled to $220 billion, but private and official shares had shifted radically: private flows ($200 billion) now accounted for 91 percent of all net external capital flowing to the developing world, and official flows ($20 billion) only 9 percent (Table 1-1).

Net external private capital flows consist of (1) FDI, (2) portfolio equity, and (3) private commercial debt.[3] The growth of these flows, however, has essentially been a function of the increase in FDI. In 1990, all net external flows of private capital amounted to about $55 billion, made up of FDI ($24 billion); portfolio equity ($3 billion); and private debt, both long- and short-term loans (more than $28 billion). But by 2003, FDI supplied $135 billion to the developing world, while portfolio equity and debt provided $14 billion and $51 billion, respectively. In the 13-year period, the value of FDI had risen nearly six-fold and its share of total net private flows had gone from 43 percent to more

Ireland's Growth Fueled by FDI

After a decade of sustained economic growth, Ireland employed more people in 2004 than at any time since its inception as a State. It enjoys living standards, as measured by gross domestic product (GDP), that exceed the European Union average. Its government indebtedness is now the second lowest in the euro-zone. Flows of FDI into Ireland fueled this growth. FDI increased from an annual average of about $140 million in the 1980s to $2.7 billion in the second half of the 1990s. As a result, Ireland's total inward stock of FDI reached $193 billion in 2003, second only to Hong Kong in per capita terms. Throughout this period, the foreign-owned sector contributed significantly to growth in output, exports, and employment. And through a multiplier effect, its prosperity benefited the indigenous sector by creating jobs, developing skills, and improving quality in general.

Table 1-1

Net Total Resource Flows to All Developing Countries, by Source, 1970, 1980, and 1990–2003 (US$ billion)

Year	Net Total Resource Flows	Net Private Flows				Net Official Flows		
		Total	FDI	Portfolio Equity	Debt [a]	Total	Debt [b]	Grants
1970	10.3	5.5	2.1	0.0	3.5	4.7	2.9	1.8
1980	114.1	77.3	6.3	0.0	71.1	36.7	23.9	12.8
1990	109.5	55.4	24.0	3.0	28.4	54.1	26.5	27.7
1991	135.8	74.1	33.1	6.5	34.4	61.7	30.9	30.8
1992	181.5	128.4	45.4	13.0	70.0	53.1	24.1	29.0
1993	245.2	193.6	68.1	42.4	83.1	51.6	25.6	26.0
1994	227.8	181.5	89.9	35.8	55.8	46.3	16.2	30.1
1995	288.6	234.7	105.3	17.3	112.1	53.9	39.2	14.7
1996	302.7	273.0	127.6	32.9	112.5	29.7	3.9	25.7
1997	320.9	285.8	171.1	22.6	92.2	35.1	13.2	21.9
1998	252.4	205.5	175.6	6.6	23.4	46.9	34.2	12.6
1999	238.9	194.5	181.7	12.6	0.1	44.4	13.7	30.7
2000	204.3	170.9	162.2	12.6	-3.9	33.5	-5.9	39.4
2001	186.6	151.3	175.0	4.4	-28.1	35.3	26.9	8.4
2002	176.6	155.3	147.1	4.9	3.2	21.3	4.1	17.2
2003	220.2	200.2	135.2	14.3	50.6	20.0	-6.3	26.3

[a] Includes short-and long-term debt.
[b] Includes net IMF financing flows.

SOURCE: World Bank, Global Development Finance Database.

than two-thirds, dwarfing the increase in portfolio equity and debt. Moreover, while all components of private capital rose and fell during this period, peaks and valleys for FDI were much less extreme than for portfolio equity or debt. Hence, by this century, FDI had become the developing world's largest and most durable source of external capital (Figure 1-1).

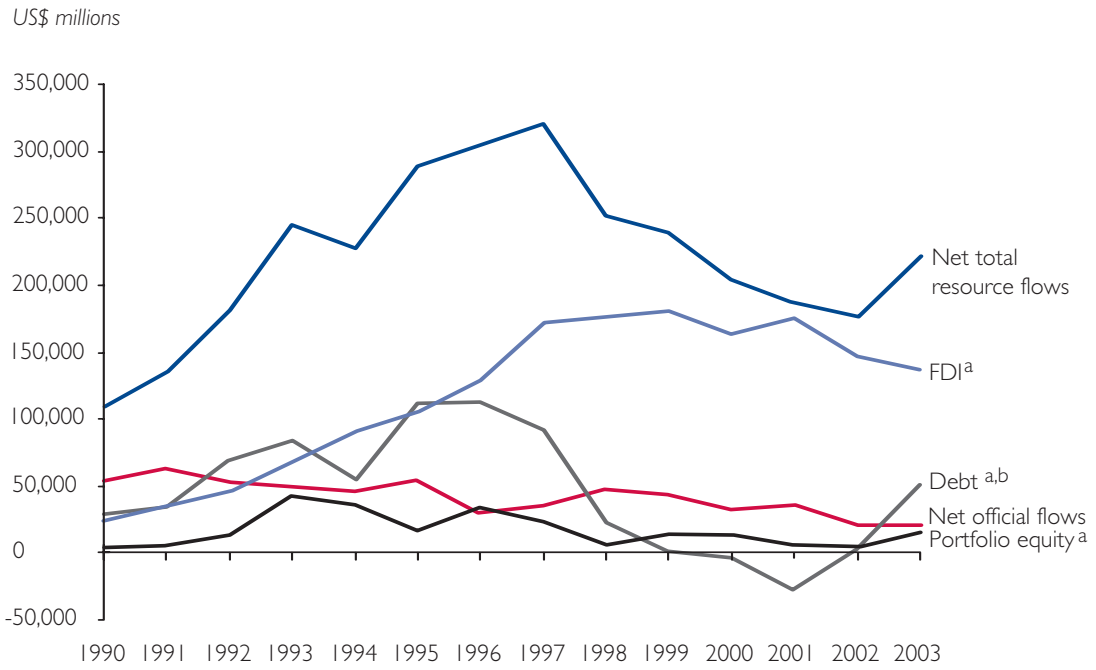
FDI AS SUPPLEMENT TO DOMESTIC INVESTMENT

As important as FDI now is as an external source of long-term investable funds, capital accumulation for development remains first and foremost an issue of domestic investment. For the developing world, all investment—measured as gross fixed capital formation, or total public and private sector investment in plant, equipment, and inventory changes—amounted to an estimated $1.4 trillion in 2003. Gross FDI inflows for that year were only about $146 billion, or just 10 percent of the developing world's total annual gross fixed capital formation. Therefore, at least 90 percent (more than $1.3 trillion) of developing countries' total 2003 investment was supplied by domestic sources of capital, private and public. Though in the 1990s the share of FDI in gross fixed capital formation rose as high as 15 percent at one point (1999), it never exceeded this number, and fell to as low as 2–3 percent (Figure 1-2). In sum, FDI must be viewed as a *supplement* to domestic investment, albeit a very significant one, for the reasons described below.

SPILLOVERS FOR PRODUCTIVITY

The value of foreign direct investment to the developing world runs well beyond the investable funds it channels into capital accumulation. FDI can be a uniquely powerful force in

Figure 1-1
Net Total Resource Flows to All Developing Countries by Source, 1990–2003



[a] Net private flows.
[b] Includes short-term and long-term debt.

SOURCE: World Bank, Global Development Finance Database.

stimulating competition, spurring innovation, introducing new technologies and processes, and elevating skills among workers and managers in developing countries. These positive effects can benefit not only the foreign affiliates directly receiving FDI, but also host-country firms that supply the affiliates, distribute their products, or even compete with them.

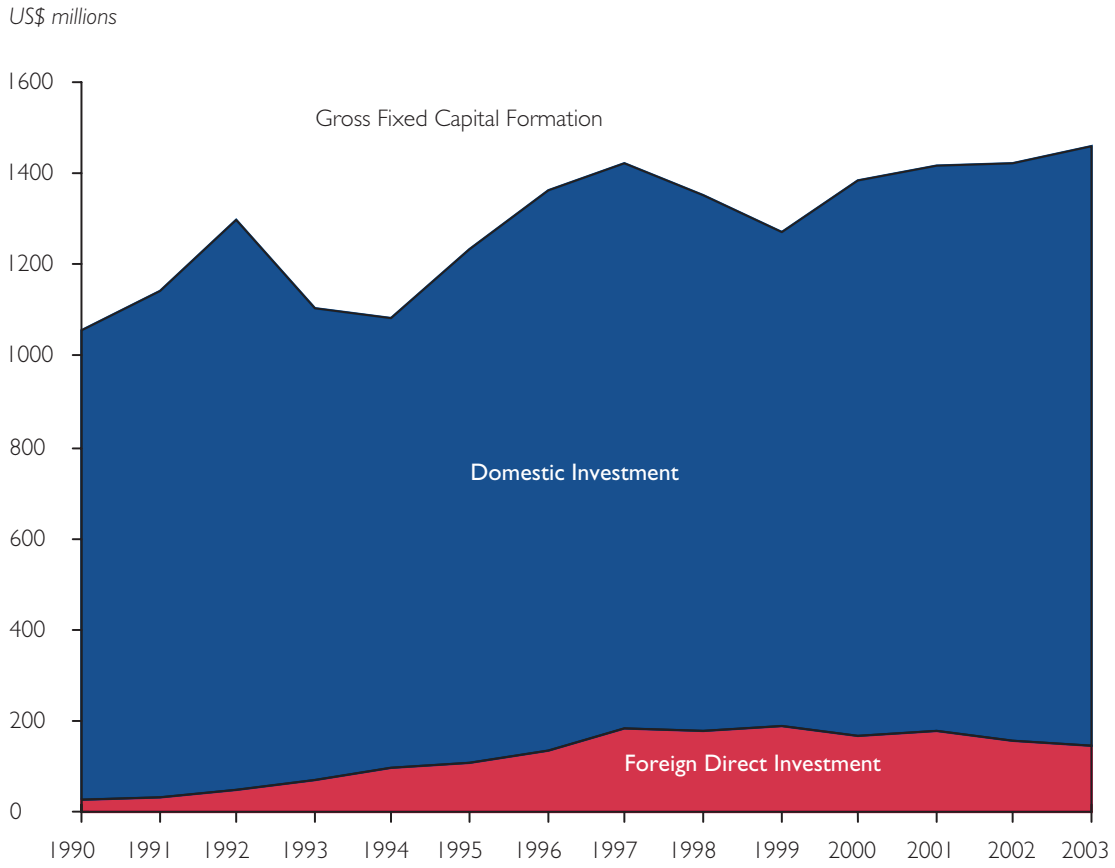
FDI is particularly well suited for rapidly and efficiently transferring and encouraging adoption of "best practices," a key to achieving economic growth and to transforming it into broad-based development. Before the industrial revolution, it took some 350 years for income per capita to double in Europe. Toward the end of the 20th century, for countries such as Botswana, Chile, China, and Thailand, it took only about 10 years to double per capita income. Developing countries can now achieve such rapid growth by importing and imitating best practices in technology and in organizational innovations from the world's leading economies. Of course, individual best practices can be conveyed across borders by various non-equity mechanisms, including contract export production to buyer specifications, patent licensing, franchising, management contracting, and the like. But only FDI offers investment capital, technology, managerial skills, and access to export markets—all in one package. But what, precisely, constitutes foreign direct investment?

FOREIGN DIRECT INVESTMENT DEFINED

For purposes of statistical and policy analysis, the official definitions of FDI are provided by the International Monetary Fund (IMF) and the Organisation for Economic Co-operation and Development (OECD).[4]

Figure 1-2

Total Domestic Investment and Foreign Direct Investment in Developing Countries, Annually, 1990–2003



SOURCE: UNCTAD, *World Investment Report 2004.*

DURABLE OWNERSHIP AND INFLUENCE ON MANAGEMENT

According to the fifth edition of the IMF's *Balance of Payments Manual*, FDI occurs when a resident in one economy (the "direct investor" or "parent enterprise") obtains a lasting interest in an enterprise in another economy (the "direct investment enterprise" or foreign affiliate). Lasting interest implies a durable, long-term relationship between the parent enterprise and the foreign affiliate, as well as a significant degree of influence by the former on the management of the latter. A direct investment relationship is established when the parent has acquired 10 percent or more of the ordinary shares or voting power in the affiliate.

The foreign affiliate can be an entirely new operation (e.g., greenfield investment), or the transformation of an existing one through a merger and acquisition. This affiliate can be a subsidiary, an associate firm, or a branch in which the parent enterprise has equity. The parent enterprise can be an individual or a firm. Together, the parent and its affiliate(s) form a multinational enterprise.[5]

A parent enterprise may undertake an FDI transaction in a foreign host country for a variety of reasons—to reach markets, to tap cost-effective labor, or to exploit natural resources. Or it may need to diversify its corporate assets on a global basis or desire to

Singapore's Rise and FDI

Throughout the world, Singapore is regarded as a major economic success. In the past 40 years the city-state has transformed itself from a developing country to a high-income one, and a world-class business capital. Attracting FDI has been one key to its success—annual FDI inflows were about $90 million in 1970, but are $11.4 billion today. By harnessing the technological and business power of multinational enterprise associated with these flows, Singapore rapidly moved from a labor-intensive economy to one increasingly based on knowledge and technology. Its Local Industry Upgrading Program, Skills Development Fund, and schemes to encourage local research and development by multinational companies have all been highly effective in this regard. All of these initiatives build on Singapore's excellent systems of basic education and worker training.

In maximizing FDI impacts, Singapore has adopted a carefully managed industrial policy, but one which rests on five important features: (1) an open economy that imposes market discipline; (2) excellent infrastructure and a predictable, business-friendly investment climate to attract FDI; (3) an open labor market; (4) a high-quality professional civil service; and (5) meritocratic, results-oriented government, able to rapidly recover and correct its mistakes. See Asian Development Bank, *Asian Development Outlook 2004*, Part 3 "Foreign Direct Investment in Developing Asia," pp. 230-231.

attain special synergies for certain home country assets in partnership with the foreign affiliate in the host country. Rationales for FDI are addressed in Chapter 2.

COMPONENTS OF FDI

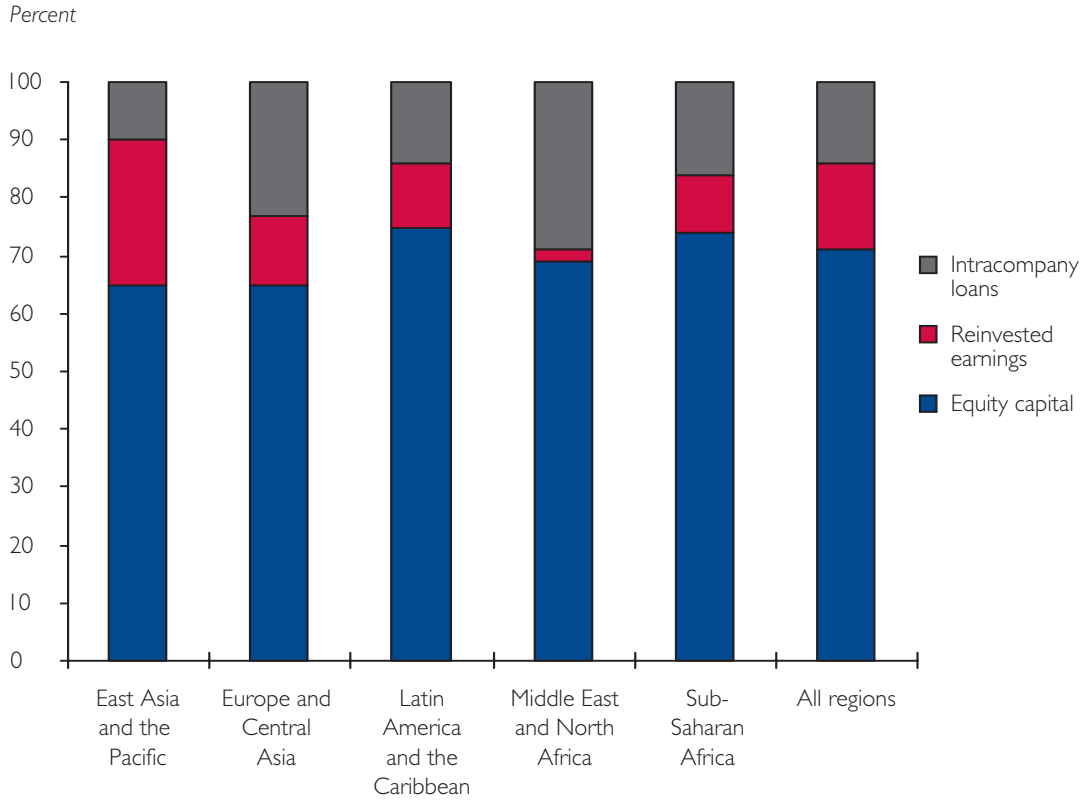
A foreign direct investment is established in the initial transaction between the parent enterprise and the foreign affiliate, but all subsequent transactions are also FDI flows. As a result, while the conventional image of an FDI transaction concentrates on the parent's initial investment of capital in the affiliate, the overall composition of flows between the two may be more complicated. Again, according to IMF and OECD norms, FDI has three possible components:

- ***Equity capital,*** in the form of the parent enterprise's direct purchase of shares in the foreign affiliate.
- ***Reinvested earnings,*** specifically earnings not distributed as dividends or earnings of branches not remitted to the parent enterprise. These retained profits are reinvested in the foreign affiliate.
- ***Intracompany debt,*** transactions between the parent enterprise and the foreign affilate. Such debt transactions could encompass borrowing and lending of funds, debt securities, and trade credits between the parent and its foreign affiliates and among foreign affiliates.

Reporting and statistics on these flows are fragmentary, especially in developing countries and especially for the reinvested retained earnings component. Recent World Bank estimates, however, indicate that in the period 1995–2002 equity capital may have made up more than two-thirds of the FDI flows to developing countries, with reinvested earnings and intracompany loans splitting the balance (Figure 1-3). These proportions may differ by region, probably because of the nature of FDI-financed affiliates in each region. For example, equity capital may

Figure 1-3

Estimated Average Composition of FDI Flows by Region, 1995–2002



Note: Estimated average compositions weighted average for 1995–2002; data for South Asia unavailable.

SOURCE: World Bank, *Global Development Finance: Harnessing Cyclical Gains for Development 2004*, Volume 1.

Volatility in Private Capital Flows to the Developing World

As a source of development capital, the durability of FDI is in stark contrast to the volatility of portfolio equity and debt. Portfolio equity players typically seek financial market investments with a much shorter time horizon, and respond quickly and dramatically to changes in economic circumstances. Likewise, lenders can call or rapidly reduce credit in economic downturns. Thus, net portfolio equity flows to the developing world scaled up rapidly in the mid-1990s to about $40 billion, only to drop sharply to $4 billion by 2001 in the wake of the Asian Financial Crisis. And private debt—long- and medium-term commercial bank loans, bonds, and other credits, plus short-term debt—followed a similar path, escalating to $92 billion in inflows to the developing world by 1997, but by 2000 becoming negative net outflows of capital from developing countries (Table 1-1).

account for a larger share of Latin America's FDI because of cross-border mergers and acquisitions that occurred in the late 1990s. In sub-Saharan Africa or the Middle East and North Africa, where a major share of FDI is tied to petroleum and other extractive industry projects, large-scale equity is important, but balanced somewhat by greater shares of intracompany loans, perhaps to reduce risk or to offset problems with profit repatriation.

This mix of FDI components is important because each component appears to have different volatility characteristics. Equity capital tends to be stable, even during a financial crisis—equity arrangements are likely to be complex to unwind. In contrast, reinvested earnings, and especially intracompany loans, are far more volatile, as parent companies and their foreign affiliates use them to reduce exposure to risk in response to changing economic conditions.[6] During the Asian financial crisis and Brazil's recent period of economic stress, for example, foreign affiliates increased loan repayments and repatriation of earnings to parent enterprises to offset the risk of the latter's more permanent equity capital commitments.[7]

2. THE CASE FOR FDI

The governments of many developing countries once regarded foreign direct investment with suspicion, fearing economic domination by multinational enterprises. This is no longer the case. Now investment promotion agencies in developing countries pursue FDI aggressively. International business has expanded FDI activity dramatically because it makes business sense to do so. This reversal of attitude is the result of the undeniable benefits of FDI—regarded as integral to the development success of countries as diverse as Ireland, Costa Rica, and Mauritius.

THE BUSINESS CASE

Foreign direct investment is a business transaction. Any understanding of how FDI works and how it benefits host countries must begin with an understanding of what foreign direct investors are seeking when they invest—natural resources, markets, production efficiency, or strategic assets (Table 2-1).[1]

NATURAL RESOURCE-SEEKING FDI

Access to natural resources has motivated foreign direct investment since before the 19th century. Focused largely on the extractive industries of oil- or mineral-rich developing countries, this investment has also encompassed forest resources, plantation agricultural production, and large-scale fisheries—all of which capitalize on the natural endowments of geography, climate, geology, and water. Much FDI-financed exploitation of natural resources has taken the form of extraction and export of primary commodities in bulk form. In some cases, however, FDI has led to the establishment of facilities for processing, packaging, and transporting extractive resources and primary agricultural products. At this point, natural resource-seeking FDI probably accounts for only about 6 to 7 percent of the total accumulated stock of FDI in the developing world.

MARKET-SEEKING FDI

The pursuit of markets has long motivated investment in the developing world, especially for manufacturers in the era of import-substitution policies. Steep barriers to imports, including tariffs, meant that foreign firms could reach markets in developing countries only by "tariff-hopping"— investing directly in foreign affiliates in those markets. FDI was an alternative to exporting. Now that trade policy liberalization has greatly reduced import barriers, tariff-hopping has declined, but the market-seeking motive is still strong for three reasons.

First, many foreign investors in manufacturing still find FDI the most effective way to tap into a foreign customer base, even when foreign markets are relatively open (e.g., minimal national

or common external tariffs). Local production may, for example, cut transport costs or avoid the high production costs of the home country, or it may help the manufacturer meet local preferences to an extent not possible at the long distances typical of exporting. Customers' cost expectations or just-in-time production techniques often require FDI-financed proximity. Second, the wave of regional trade agreements and preferential access arrangements has reinforced market-seeking investment.[2] The openings to otherwise-restricted regional and third-country markets that such trade pacts provide can make a production site attractive and stimulate FDI—as rising Japanese FDI in Mexico under NAFTA or European Union FDI in MERCOSUR have demonstrated.[3] Third, many services are not tradable and must be produced where they are consumed. Serving customers and clients—in banking, transport, retail distribution, public utilities, or communications—demands a presence in the host-country market, and this presence is created through direct investment in foreign affiliates. In total, market-seeking FDI may now account for more than half the accumulated stock of FDI in the developing world.

EFFICIENCY-SEEKING FDI

In the 1990s multinational manufacturing enterprises began to disaggregate production and relocate the pieces wherever they could be performed most efficiently. Disaggregating and "offshoring" a production process often required FDI projects to set up foreign affiliates to handle the relocated tasks. This desire for operational efficiency accounts for much of the enormous FDI inflows to China and other locations in Asia.

The Global Factory—Catalyst for Efficiency-seeking FDI

The concept of the "global factory" lies behind the rise of efficiency-seeking FDI in manufacturing. Traditionally, entire manufacturing processes were location-bound. In the 1990s export opportunities arising from liberalized trade regimes and intense global competition changed this pattern. Profiting from advances in transport, communications, and IT, multinational enterprises now organize global production networks that cross national boundaries. The networks are a disaggregation of value-added production into many discrete pieces, each piece varying by the intensity of its capital, skilled labor, unskilled labor, and other input needs. The multinational then assigns these pieces to units around the world. The units are often created as FDI-financed foreign affiliates. Each unit delivers the best cost-productivity characteristics in the network relative to its piece of the production process. This global factory represents the most efficient configuration of the value chain and maximizes the competitive advantage of the multinational enterprise that created it. But the configuration is not static; it shifts fluidly in response to changing production costs, requirements of regional trade agreements, exchange rates, and other factors. The spread of the global factory is evident in the UN's Comtrade database, which shows that in the 1981 to 2000 period, annual exports of parts and components—a proxy for participation in global production networks—rose at a rate 2 percent higher than that of exports of manufactured goods. Further, the share of developing countries in parts and components exports rose from 4 percent in 1981 to 21 percent in 2000. See *Global Economic Prospects and the Developing Countries 2003*, especially Chapter 2, "Changes in Global Business Organization," pp. 45-65.

Table 2-1
Foreign Direct Investment Motives and Host-Country Attributes

Motive for Investment	Host-Country Attribute
Resources or Assets	• Raw materials/primary commodities
Markets	• Market size and per capita income • Market growth • Access to regional and third-country markets • Country-specific consumer preferences • Proximity to strategic clients • Structure of markets (concentration, price structure)
Efficiency	• Low-cost unskilled labor • Skilled labor • Other input costs (e.g., transport and communications to/from host economy) and costs of intermediate products • Membership in a regional integration agreement conducive to the establishment of regional corporate networks
Strategic Assets	• Created assets based on technology or innovation (e.g., brand names) • Created assets embodied in individuals, firms, industry clusters (e.g., R&D capabilities) • Physical infrastructure (ports, roads, power, telecommunications)

SOURCE: Nathan Associates, based on UNCTAD, *World Investment Report 2003*, p. 85.

The global production networks that resulted from this efficiency-seeking FDI now account for much of the world's manufacture of electronics, automobiles, and other transport equipment and industrial machinery. Developing countries' low-cost, high-productivity labor has been their point of entry into the networks. The investments of Japanese firms in Asia, U.S. firms in Mexico and Central America, and EU firms in Central and Eastern Europe all cut costs by dispersing labor-intensive manufacturing to locations in the developing world. When labor demand and productivity rise, real wages increase and some offshore locations lose their cost advantages. At this point, these locations are assigned more sophisticated production stages better suited to their improved labor skills, productivity, and manufacturing experience, and their former role in the production process is reassigned to less-advanced locations.[4]

Efficiency-seeking FDI in services is now growing even more rapidly than in manufacturing. Firms have lowered costs and boosted productivity by applying the "global factory" model to services. Developed country multinationals have set up foreign affiliates to provide data processing or call-center operations, inventory management, quality control, accounting, reservations, and personnel services. They have also organized the export delivery of professional services, such as engineering, architectural and product design, and research and development through foreign affiliates. What has stimulated this efficiency-seeking investment in services? Rising world incomes, which increase demand for services; technological advances, which make possible the disaggregation and management of service value chains; and deregulation, which has allowed for private provision of services in public utilities.[5]

Together, efficiency-seeking FDI in manufacturing and services may now represent more than one-third of the total accumulated stock of FDI in the developing world.

STRATEGIC ASSET-SEEKING FDI

When foreign direct investors perceive special synergies between their operations and a given foreign asset, they are motivated to acquire that

asset. The asset is usually unique—valuable research and development capabilities, specialized management skills and systems, infrastructure, or a brand with market power. Much foreign direct investment in airline privatizations in the 1990s was strategic asset-seeking, motivated by a desire on the part of one airline to share in another's traffic rights and airport hub operations (e.g., KLM's investment in Kenya Airways to gain use of the latter's Nairobi hub, and to profit from KA's air traffic rights between Europe and Africa). Similarly, in recently acquiring IBM's personal computer business at a cost of $1.75 billion the Lenovo Group, China's largest computer maker, invested in a strategic asset. In this transaction, the investor held that "the most valuable asset … acquired was [IBM's] world class management team and their extensive international experience."[6] Undertaken mostly in developed countries through mergers and acquisitions, this type of FDI is small but growing in developing countries.

THE DEVELOPMENT CASE

Policymakers in developing countries are well aware that FDI represents only a fraction of total annual investment in the developing world, as noted earlier. For example, for the five-year period 1999–2003, FDI accounted for just 12 percent of all investment in developing countries and less than 3 percent of their combined GDP (Table 2-2). While these ratios vary by region—in Africa and Latin America FDI has been a relatively larger factor in total investment—it is clear that FDI can only be regarded as a supplement to domestic investment.

Nevertheless, for developing countries, the reasons for hosting FDI remain very compelling: FDI contributes directly to economic growth while it also reinforces and accelerates economic development in ways that can transform an economy more quickly or dramatically than domestic investment alone.

ECONOMIC GROWTH

Developing countries often see FDI as a growth-inducing flow of financial resources. In this version of the traditional investment–growth paradigm, the effect of FDI is little different than the effect of domestic investment. The presumption is that FDI adds to domestic savings and raises rates of capital accumulation in both physical and human resource assets. In competitive environments, high-quality FDI projects elevate the rate of return to investment in the economy as a whole. These projects lead to new employment and wages and this in turn creates more jobs and income in progressively wider circles of the economy. The result is increased economic growth.

Table 2-2
Total Gross Fixed Capital Formation and FDI Relative to Gross Domestic Product, for All Developing Countries, 1999–2003, by Region (US$ million)

Region	GDP	GFCF [a]	% GDP	FDI	% GDP	% GFCF
Developing Countries	31,019,516	6,956,272	22.4	838,392	2.7	12.1
East Asia and the Pacific	8,495,510	2,628,952	30.9	270,265	3.2	10.3
Europe and Central Asia	5,373,277	1,076,450	20.0	155,347	2.9	14.4
Latin America and the Caribbean	9,110,786	1,697,645	18.6	323,582	3.6	19.1
Middle East and North Africa	3,129,820	640,833	20.5	19,154	0.6	3.0
South Asia	3,172,161	648,689	20.4	20,779	0.7	3.2
Sub-Saharan Africa	1,737,962	263,704	15.2	49,265	2.8	18.7

[a] Gross fixed capital formation.

SOURCE: Nathan Associates, based on UNCTAD databases on GDP, GFCF, and FDI.

The Impact of Coca-Cola in China

Since reentering the Chinese market in 1979, Coca-Cola has become a major foreign investor there. By 2000, it was running 28 bottling plants, calling for capital investments and direct operating expenditures (excluding labor costs) of more than $1.1 billion, wage and salary payments of $100 million, and a workforce of 14,000. Its operations gave rise to 350,000 jobs among suppliers and 50,000 jobs among independent wholesalers and retailers. By injecting $1.1 billion into the economy it generated another $2.6 billion in further rounds of expenditure. More important is the firm's effect on development. It revolutionized supply linkages by working with suppliers to upgrade their offerings. Glass bottles once imported from Korea are now produced by local firms trained by Coca-Cola's glass technologists. The firm now purchases 98 percent of all production inputs in China. To be a Coca-Cola supplier is a "stamp of approval" and generates additional business. And because the firm's business involves a complex web of retailers, wholesalers, and vendors, it has transmitted competitive business practices to a new generation of entrepreneurs. In transforming its bottling plants from backward, inefficient state-owned enterprises into successful joint ventures, it restructured enterprises, introduced management accountability and worker incentives, and created a firm-wide market-sensitive culture. Coca-Cola trained its workforce, retailers, and wholesalers in marketing and other skills. Its Soft Drink Training Center at Tianjin now provides training in business and technical subjects for employees and private sector and government managers from all over China.

SOURCE: *Economic Impact of the Coca-Cola System on China*, Peking University, Tsinghua University and University of South Carolina. August 2000.

Empirical tests of the relationship between FDI, capital accumulation, and economic growth are encouraging if not uniform. It appears, first of all, that FDI has a positive effect on capital formation; increases in FDI generally lead to increases in aggregate domestic investment. Nor does FDI seem to "crowd out" domestic investment—by stimulating complementary activity FDI projects may actually "crowd in" such investment. But these positive effects may depend heavily on conditions and policies in host countries. Competitive open markets favor FDI's boost to investment.[7]

Empirical evidence of a positive relationship between FDI and economic growth in developing countries is also substantial. In export-oriented economies or economies with a relatively well-trained workforce, for example, FDI appears to directly affect the rate of growth. In other situations, causality is less clear; accelerated economic growth may increase FDI as much as the reverse. Again, it seems reasonable to conclude that in a proper policy framework, FDI can foster conditions that spur economic growth and help create a "virtuous circle" of FDI-investment-growth-FDI.[8]

UNIQUE ADVANTAGES FOR DEVELOPMENT

FDI's role in development may begin with its contribution to capital accumulation and economic growth, but its full value is much greater. Under the right conditions, unique productivity-enhancing effects not found in other types of development finance accompany FDI.

Increased trade and global economic integration. In the last quarter century, trade and FDI flows

have increased rapidly in the developing world, by about 6 percent and nearly 15 percent, respectively, between 1978 and 2001. The two reinforce each other: FDI creates trade and trade improves resource allocation and creates new incentives for FDI, especially in its efficiency-seeking form. The result is a general rise in levels of productivity among developing world firms: FDI builds the export capacity and competitiveness of these firms, enabling them to enter the world trading system through integration into global production networks.[9]

Technology transfer. FDI-financed foreign affiliates introduce new technologies in production processes and in management and organization of economic activity at the firm level. This may be the strongest single effect of FDI, since by definition developing countries face a technology gap, and multinational enterprises can supply know-how that fills that gap. Evidence that FDI raises productivity in recipient industries and firms is considerable.[10] In addition, FDI-generated technology transfer is particularly likely to occur through linkages with local suppliers. Training, technical advice, and information improve suppliers' productivity and product quality. For transfers to work best, however, the gap between the host country's initial level of technology and that of the foreign affiliate must not be too pronounced. Intensity of competition, the quality of education in host countries, training and personnel policies in foreign affiliates, and labor market structure and mobility all influence the effectiveness of technology transfer. A strong policy framework is also critical.[11]

Human capital formation. Closely tied to technology transfer is the impact of FDI on human capital. FDI-based foreign affiliates usually provide more training and skill development than domestic enterprises. Staff turnover among multinationals tends to be lower than among domestic firms, so the affiliates may internalize much of this skills upgrading. Many trained managers and technicians, however, do move on to other jobs, stimulating broader benefits to the economy. Moreover, important training spillovers occur through vertical linkages, and, when affiliates support industry and regional skill development institutions, through horizontal linkages. And individuals once employed as specialists by foreign affiliates also expand human capital when they become entrepreneurs.[12]

Competition and enterprise development. When a foreign affiliate enters a domestic market competition can increase, requiring all enterprises to become more efficient or diminish or even perish. Along with opening markets to international trade, enforcement of sensible competition laws is the most effective way to harness the efficiency-inducing effects of FDI. This ensures that the heightened competition with domestic firms stimulated by FDI-financed foreign affiliates occurs within a rational, pro-competitive market environment. FDI, through privatization and mergers and acquisitions, tends to improve management systems and corporate governance, blending local knowledge with the best practices of foreign managers and technicians. The privatization of state-owned utilities in Eastern Europe offers solid evidence of FDI's positive effect on competitive efficiency.[13]

Though differing in kind, these four advantages of FDI share one requirement for full impact: a framework of competitive, open, and market-oriented economic policies and institutions. If foreign affiliates are to boost productivity and host-country firms are to respond competitively, then appropriate legal and regulatory structures and rules must complement the discipline of open markets and trade.

In fact, it is when these structures are absent that the potential costs of FDI arise most severely. For example, better organized and more efficient foreign firms entering a host-country economy can certainly crowd out weaker domestic rivals, as noted above. And the process of adjustment that this touches off entails real costs for displaced firms that must rapidly restructure to survive, and for displaced workers who must find new jobs. But the solution to this problem is not to prevent the entry of FDI and preserve inefficiency. Rather, it is to

welcome the productivity-enhancing possibilities of FDI by creating a flexible business climate and labor market where local firms and workers can respond and adapt to new opportunities.

FDI MOTIVATIONS AND DEVELOPMENT

All forms of FDI can generate capital accumulation, employment, and income growth, but not all necessarily increase economic integration, transfer technology, upgrade human capital, and spur competition. Efficiency- and market-seeking FDI—whether in manufacturing or services—are the most likely to do so. For example, efficiency-seeking FDI can raise host-country competitive advantage by introducing new production technologies, product or service requirements, and managerial practices, thereby establishing the host's reputation for quality, reliability, and productivity. When efficiency-seeking manufacturers begin taking root they involve themselves with local suppliers to good effect. Likewise, efficiency-seeking service providers raise the host country's trade competitiveness by cutting the costs of intermediate services that support exporting—banking, insurance, business support services, transport, electricity, and telecommunications.

Market-seeking FDI has the same positive impact, especially in service industries through transfers of "soft" technology (market awareness, customer service expertise, organizational and management skills). Transfer may occur directly through training or indirectly by "demonstration effect." For example, foreign affiliates of wholesalers and retailers such as Carrefour and Wal-Mart have introduced new information management processes, pricing approaches, and marketing and merchandising methods into developing country markets. The resulting competition in local markets persuades local wholesalers and retailers to adopt new methods, improve productivity and efficiency, and train workers. These same effects are evident in tourism and manufacturing. Innovation and improvements in quality, price, and efficiency all ensue—absent trade restrictions, barriers to entry, and favoring of state-owned enterprises.

In contrast, natural resource-seeking FDI has a mixed impact on development. FDI to extract oil and minerals can lead to significant export earnings, but tends to be isolated physically and by sector, yielding minimal additional value for the host country.[14] When such FDI focuses on large-scale agriculture or fisheries, however, it can create new trade flows, opportunities for processing, and linkages with suppliers and local and regional supermarket chains that lead to technology transfer.

FDI AND POVERTY, LABOR, AND THE ENVIRONMENT

Much debate over globalization concentrates on the effect of trade and investment on developing countries, and the costs they might create. Skeptics take issue, for example, with the implications of FDI for poverty, labor, and the environment.

POVERTY

To some, FDI threatens to increase rather than reduce poverty in the developing world.[15] It is true that FDI often heightens competition in domestic markets, and this may force firms and workers to adjust. As a matter of fairness, such adjustments need to be accommodated within programs for structural transformation of developing country economies. However, in the final analysis, economic growth is the single most important factor in reducing poverty in the developing world. By creating jobs, boosting productivity, and raising wages, FDI reinforces growth. Through spillovers and other effects on development, FDI helps to make this growth broad-based, thus alleviating poverty. Moreover, FDI can influence the quality of growth and poverty reduction well beyond any contributions to cash incomes.[16]

Expand services to the poor. As infrastructure services have become increasingly privatized in developing countries, FDI flows have helped expand or deliver core services to the poor. Arguably, FDI has helped bring more and better telecommunications, electricity, and water

services to millions of households, including poor ones in previously underserved areas.

Boost revenues for social programs. FDI generates taxes that can be used to support the development of social safety nets for the poor. Foreign affiliates often support community development in areas where they operate, including supporting the quality or availability of health and education services.

Cushion economic shocks. Because FDI tends to be more stable than other external financing flows, it can help cushion external shocks to the poor resulting from financial downturns and credit squeezes. This happened in Southeast Asia during the Asian Financial Crisis of the late 1990s.

FDI's effect on poverty depends on the speed and intensity with which technology transfer and other secondary effects take hold. Such effects foster the broad-based growth that reduces poverty. Thus, developing countries have all the more reason to promote linkages between FDI-based foreign affiliates and local suppliers and distributors and to invest in education and training—the key variable in technology transfer and economic growth.

LABOR

Some observers of globalization assert that because countries are engaged in a "brutal competition to attract the same pool of limited FDI," they "often feel compelled to repress worker rights."[17] Access to labor—appropriately trained, in sufficient quantity, and at prices commensurate with productivity—attracts FDI, especially the efficiency-seeking variety. Surveys of multinational investors suggest that FDI-based firms tend to pay higher wages, offer superior benefit packages, and provide more training than host-country domestic firms.[18] Further, FDI-based firms generally pay higher wages for both high-skilled and low-skilled labor, though the premium is normally larger for the highly skilled. Empirical evidence also suggests that employment in export processing zones is more remunerative than employment in other areas of the economy.[19]

Nevertheless, low labor standards and violation of trade union rights have been a concern in the foreign affiliates of some multinationals. Abuses are abetted by the poor labor practices of certain multinationals and weak labor law enforcement capabilities of various host countries. No organization enforces international labor standards among foreign investors, but multinational corporations are increasingly committed to self-regulatory mechanisms such as product labeling, branding, and codes of conduct. The International Labor Organization's Multinational Enterprises and Social Policy Program fosters widespread observance of the Tripartite Declaration of Principles. This declaration provides a framework for action by governments, employees, and multinational enterprises to address labor and social issues. Moreover, OECD members have agreed to the Declaration on International Investment and Multinational Enterprises, which contains non-binding guidelines to help foreign enterprises operate in harmony with government policies and societal expectations.

ENVIRONMENT

Multinational corporations have been accused of creating "pollution havens" in developing countries by funneling FDI to locations with lower environmental standards than those in their home countries.[20] Whether FDI improves, worsens, or has no effect on a host country's environment depends on the sector to which FDI is flowing, the decisions about technology made by the firms involved, and the host country's own environmental regulations and capacity for enforcement.

At the sector and firm levels, multinational enterprises have choices when it comes to their environmental performance. Should they invest in newer, cleaner technologies and processes or use older, "dirtier" technologies and equipment? Should they impose the same environmental management systems on foreign sites that they

are obligated to use in their home country, or should they follow local standards? Environmental sensitivity appears strong in high-tech sectors, where companies tend to adopt international best practices or company-wide policies. It lags in the extractive industries, which tend to be guided by local practices and regulations, rather than more costly best practices.

Have FDI-based firms raised or lowered the bar for environmental regulation in host countries? Foreign mining companies in Chile have pressed for more coherent environmental regulation, while foreign oil companies in Russia have flouted the country's new environmental laws. The capacity of local regulatory institutions and the political will for enforcement are also important. If oversight is limited and political will is weak, producers must self-regulate, FDI-based firms among them.

Overall, multinational corporations in developing countries seem to act no better or worse than domestic firms in environmental matters.[21] To maximize the likelihood that FDI does not harm or that it even improves the environment, developing countries should consider (1) building regulatory capacity; (2) incorporating regulations and sustainability requirements into their economic growth strategies and specific policies for business and industry, both foreign and domestic; and (3) pressing parent firms and their foreign affiliates to regard good environmental practice as a spillover effect expected of FDI.

3. TRENDS AND PATTERNS IN FDI FLOWS

Foreign direct investment inflows to the developing world exploded more than seven-fold in the 1990s, only to decline precipitously in the first years of the new century. More recently, signs of a recovery in FDI are emerging. On a global scale, FDI flows have followed a similar path. Underlying these general trends are uneven patterns of FDI distribution in the developing world. The unevenness is evident by country and region, and by countries grouped according to income level. Recognizing FDI's broad patterns and geography is essential to understanding past FDI performance in the developing world, and to establishing a context for analysis of future FDI flows.

OVERALL TRENDS

Developing countries now capture $146 billion in FDI inflows, or about 26 percent of the roughly $560 billion in worldwide inflows recorded in 2003. Though below mid- to late-1990s levels, this share of global FDI is still substantially larger than that held by the developing world at the beginning of the 1990s (Table 3-1). Experience now shows that in good economic times and bad, FDI remains a persistent force in the key economies of the developing world.

DECADE OF MASSIVE INFLOWS

In the 1990s, developing countries experienced a dramatic rise in FDI inflows, from $26 billion in 1990 to $188 billion in 1999, an increase of nearly 630 percent.[1] Four factors seemed to account for this surge:

1. Extensive investment by multinationals in the ***privatization of state-owned assets***, particularly in Latin America and Eastern Europe.
2. Acquisitions of ***distressed banks*** by foreign investors after the 1997 Asian Financial Crisis.
3. A wave of ***international corporate crossborder mergers and acquisitions***—many between developed and developing countries—outside the financial sector.
4. The rapidly growing attraction of ***China as an investment destination***, for reasons of low production cost, market access, and progressive improvements in the business environment.

This rise mirrored worldwide FDI growth: global inflows shot from $209 billion in 1990 to almost $1.4 trillion in 2000, an increase of almost 570 percent (Figure 3-1).[2]

Table 3-1

Total FDI Inflows, Worldwide and Developing Countries by Region, 1970, 1980, and 1990–2003 (US$ billion)

			Developing Countries[c]						
Year	World[a]	Developed Countries[b]	Total[a]	East Asia and Pacific	Europe and Central Asia	Latin America and the Caribbean	Middle East and North Africa	South Asia	Sub-Saharan Africa
1970	13.0	10.1	3.0	0.4	0.1	1.5	0.5	0.1	0.5
1980	55.0	49.4	5.6	1.4	0.0	6.5	-2.8	0.2	0.3
1990	208.6	183.0	25.6	11.2	1.3	8.6	2.8	0.5	1.2
1991	158.6	124.7	33.9	13.4	3.3	13.0	1.6	0.4	2.2
1992	166.4	119.2	47.2	21.7	5.5	14.8	2.4	0.7	1.9
1993	225.5	153.7	71.8	39.7	9.0	14.6	5.1	1.1	2.3
1994	260.8	166.4	94.3	45.9	7.7	32.6	2.9	1.6	3.6
1995	335.7	227.5	108.2	54.4	17.7	29.6	-0.6	3.0	4.2
1996	388.5	254.6	133.9	62.7	17.3	45.7	0.7	3.6	3.9
1997	488.3	307.2	181.1	65.7	24.6	71.2	6.4	4.9	8.3
1998	690.9	512.1	178.8	60.6	28.0	72.5	7.5	3.5	6.6
1999	1,086.8	898.4	188.4	52.5	29.7	91.6	2.5	3.1	8.9
2000	1,388.0	1,220.2	167.8	46.5	30.2	79.6	2.1	3.1	6.2
2001	817.6	638.8	178.8	51.1	32.8	70.5	5.7	4.0	14.7
2002	678.8	520.8	157.9	60.7	35.2	45.6	3.1	4.5	8.9
2003	559.6	414.1	145.5	59.5	27.4	36.2	5.7	6.1	10.6

[a] May not add to totals due to rounding.

[b] High-income countries according to World Bank classification (2003 per capita GNI above $9,385).

[c] Low- and middle-income countries according to World Bank classifications (2003 per capita GNI is $9,385 or below). Regional groupings are according to World Bank definitions. Based on these criteria, certain countries that UNCTAD considers "developing" (e.g., Singapore, Hong Kong, Korea, Cayman Islands, Bermuda, Brunei, Barbados, Cyprus, Taiwan, Kuwait, Qatar and UAE) the World Bank classifies as high-income and are excluded here.

SOURCES: UNCTAD, *World Investment Report 2004*; World Bank, *World Development Report 2005*.

PEAK AND SLUMP

After peaking in 1999–2000, FDI inflows declined in the developing world and in general. The decline has been particularly sharp on a global basis, with inflows dropping 60 percent between 2000 and 2003, from $1.4 trillion to just $560 billion. Inflows to developing countries also fell, but much more modestly: 23 percent between the 1999 peak and 2003, from $188 billion to $146 billion. Sluggish economic growth and poor stock market performance in developed countries, plus a continuing decline in privatizations and cross-border mergers and acquisitions, and a widespread pattern of repayment of intracompany debt by the foreign affiliates of multinational enterprises, seem to have combined to produce the global drop-off in FDI.

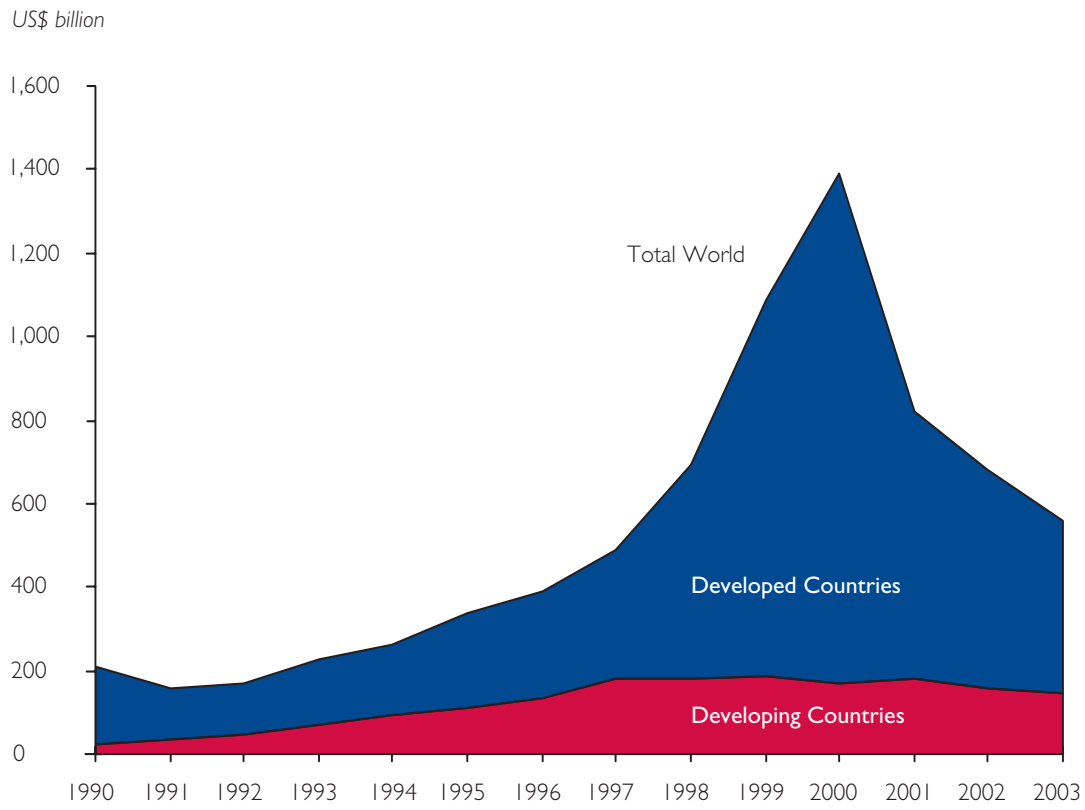
In the developing world, the picture is more nuanced. The decline in FDI inflows since 1999 appears to be largely a function of a drying up of FDI to middle-income economies, particularly in Latin America and Southeast Asia, as privatizations in the infrastructure, petroleum, and financial sectors were completed and as interest in cross-border mergers and acquisitions waned in the face of financial crises in both regions. In other parts of the developing world, including low-income countries as a group, FDI inflows

remained stable or even increased slightly between 1999 and 2003. China and India, where inflows continued to rise after 1999, are major factors in this pattern.

RISING NEAR-TERM PROSPECTS

Prospects appear favorable for a return to growth in FDI inflows to the developing world in the next couple of years, although with regional variations. This hopeful outlook depends on improving macroeconomic conditions in the world's major source economies for FDI. It also relies on a mix of positive trends in the developing world: China's attraction as an export platform and domestic market; economic recovery in some developing countries (e.g., Brazil, Poland, Mexico); and continued liberalization of foreign ownership restrictions. These favorable prospects also reflect an accelerating shift toward FDI in the services sector—where many cross-border investment opportunities are still untapped, and where many developing countries seek to attract FDI to upgrade infrastructure standards. World Bank forecast models suggest that compared to 2003 levels, net FDI inflows to the developing world may increase by

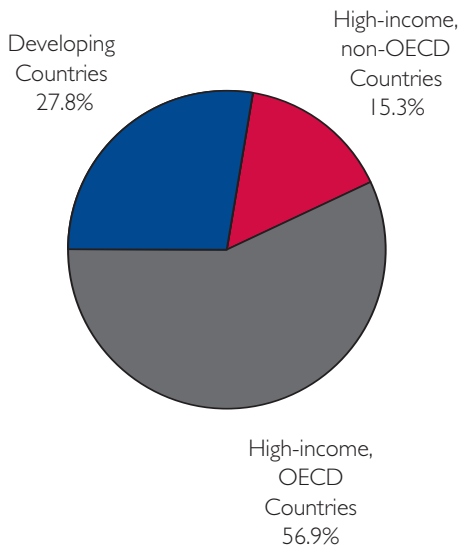
Figure 3-1
FDI Inflows, Developed and Developing Countries, 1990–2003



Note: Developed countries are high-income countries according to World Bank classification (2003 per capita GNI above US $9,385). Developing countries are low- and middle-income countries according to World Bank classifications (2003 per capita GNI is US $9,385 or below). Regional groupings are according to World Bank definitions. Based on these criteria, certain countries considered "developing" by UNCTAD (e.g., Singapore, Hong Kong, Korea, Cayman Islands, Bermuda, Brunei, Barbados, Cyprus, Taiwan, Kuwait, Qatar, and UAE) are classified as high income by the World Bank and are excluded from that definition of developing countries in these figures.

SOURCE: UNCTAD, *World Investment Report 2004*; World Bank, *World Development Report 2005*.

Figure 3-2
Estimated Sources of FDI Inflows to the Developing World, by Share of Inflows, 2001



Note: Based on a sample of 30 countries.

SOURCE: World Bank, *Global Development Finance, Harnessing Cyclical Gains for Development 2004*, Volume I, p. 81.

more than 20 percent by the end of 2005. Current UNCTAD surveys of the world's largest multinationals, as well as a broad range of other public and private sector analyses, confirm this optimism. All reveal improving investor sentiment and renewed interest in emerging markets, both encouraging signs to FDI in developing countries.[3]

SOURCES OF FDI FOR DEVELOPING COUNTRIES

Past patterns and future prospects for FDI flows to developing countries are partly a function of the economic performance of developed countries. High-income economies, both OECD and non-OECD members, generate an estimated 70 percent of FDI flows to the developing world. Assuming the pattern of FDI supplied to developing countries follows the profile of FDI outflows globally, providers are ranked roughly as follows: the United States, France, the United Kingdom, Belgium, the Netherlands, and Japan. Among non-OECD high-income countries, Singapore, Taiwan, and Hong Kong are important sources of FDI for the developing world. The balance of FDI inflows originates within developing countries (Figure 3-2). FDI flows from this source—"South–South" flows—are increasingly significant, as will be seen in Chapter 4.

COUNTRY CONCENTRATION

Though oft-cited as indicating globalization's spread and influence, FDI flows into the developing world—in absolute terms—are highly concentrated among a few countries. According to UNCTAD data for 2003, nearly two-thirds of FDI inflows to the developing world, some $93 billion, went to only ten countries (Table 3-2). China, receiving almost $54 billion in 2003, accounts for more than one-third. China's FDI numbers may be overstated—as much as 40 percent may be attributable to Chinese mainland firms "roundtripping" domestic investment through Hong Kong to take advantage of conditions and incentives open only to foreign investors.[4] Even so, China dwarfs Mexico and

Table 3-2

Top 10 and Top 20 Developing Country FDI Recipients for 1999–2003 and Their 2003 FDI Per Capita and as a Percent of GDP

		FDI (US$ billion)						FDI 2003	
Recipients	World Bank Income Classification	1999	2000	2001	2002	2003	Annual Average 1999–2003	Per capita($)	% GDP
All Developing Countries		188.4	167.8	178.8	157.9	145.5	167.7	27	2.1
Top 10									
China	LMC	40.3	40.7	46.9	52.7	53.5	46.8	42	3.8
Mexico	UMC	13.2	16.6	26.8	14.7	10.8	16.4	105	1.7
Brazil	LMC	28.6	32.8	22.5	16.6	10.1	22.1	57	2.1
Argentina	UMC	24.0	10.4	2.2	0.8	0.5	7.6	15	0.4
Poland	UMC	7.3	9.3	5.7	4.1	4.2	6.1	111	2.0
Czech Republic	UMC	6.3	5.0	5.6	8.5	2.6	5.6	253	3.0
Chile	UMC	8.8	4.9	4.2	1.9	3.0	4.5	189	4.1
Thailand	LMC	6.1	3.4	3.8	1.1	1.8	3.2	29	1.3
India	LIC	2.2	2.3	3.4	3.4	4.3	3.1	4	0.7
Hungary	UMC	3.3	2.8	3.9	2.8	2.5	3.1	245	3.0
Total		140.0	128.1	125.0	106.7	93.2	118.6	33	2.4
% of Developing Country Total		74.3	76.3	69.9	67.6	64.1	70.7		
Next 10									
Venezuela	UMC	2.9	4.7	3.7	0.8	2.5	2.9	99	3.0
Malaysia	UMC	3.9	3.8	0.6	3.2	2.5	2.8	100	2.4
Russian Federation	LMC	3.3	2.7	2.5	3.5	1.1	2.6	8	0.3
South Africa	LMC	1.5	0.9	6.8	0.8	0.8	2.1	17	0.5
Kazakhstan	LMC	1.5	1.3	2.8	2.6	2.1	2.0	139	7.0
Slovakia	UMC	0.4	1.9	1.6	4.1	0.6	1.7	106	1.8
Angola	LIC	2.5	0.9	2.1	1.6	1.4	1.7	105	10.7
Peru	LMC	1.9	0.8	1.1	2.2	1.4	1.5	51	2.3
Croatia	UMC	1.5	1.1	1.6	1.1	1.7	1.4	381	6.1
Morocco	LMC	0.8	0.2	2.8	0.5	2.3	1.3	76	5.1
Total - Next 10 Countries		20.2	18.3	25.6	20.3	16.3	20.2	49	1.7
% of Developing Country Total		10.7	10.9	14.3	12.9	11.2	12.0		
Total - top 20 countries		**160.2**	**146.4**	**150.6**	**127.0**	**109.6**	**138.8**	**35**	**2.5**
% of Developing Country Total		85.0	87.2	84.2	80.4	75.3	82.8		

Note: World Bank classification of economies according to income group, based on 2003 GNI per capita. The groups are low income (LIC), $765 or less; lower middle income (LMC), $765- $3,055; and upper middle income (UMC), $3,036-$9,385. All other countries are high income, and considered outside the category of developing countries.

SOURCES: FDI Inflows from UNCTAD, *World Investment Report 2004*, Statistical Annex; Population and GDP from World Bank, *World Development Report 2005.*

Brazil, the two next largest recipients, each with about $10 billion. Beyond this trio, no other developing country received even $5 billion in FDI in 2003.[5] Indeed, inflows to the next ten largest recipients accounted for only $16 billion, or 11 percent of FDI. The remaining $36 billion in flows recorded by UNCTAD was divided among 116 countries.

This concentration appears to be weakening, at least for the top ten recipients. This group garnered 74 percent of FDI inflows in 1999,

but only 64 percent by 2003. Shares for the next ten recipients remained stable, about 11 percent in both years. Thus, the least favored 116 countries increased their combined share of FDI inflows from 15 percent in 1999 to 25 percent in 2003.

In addition, when FDI is measured by indicators other than absolute value, country concentration breaks down. For example, if FDI inflows of the top 20 recipients in absolute terms are calculated on a per capita basis, the top recipient is Croatia with $381 FDI per capita, followed by the Czech Republic ($253) and Hungary ($245). China posts only about $42 per capita (Table 3-2). Equatorial Guinea, with 523,000 people and an oil-sector-induced FDI inflow of $1.4 billion in 2003, recorded estimated per capita FDI of $2,736 for the year, the developing world's highest figure.

REGIONAL PATTERNS

On the basis of the World Bank's definition of developing country regions, the East Asia and Pacific region is the largest FDI recipient, regaining a position it had lost to Latin America and the Caribbean during a burst of privatizations there from 1997 to 2001 (Table 3-3). The Middle East and North Africa currently ranks the lowest as a regional FDI recipient (Figure 3-3). Regional distribution is of course influenced by country concentration.

EAST ASIA AND THE PACIFIC—CHINA'S APPEAL

Because of China's appeal, East Asia's share of developing country FDI inflows has been rising steadily since 2000, and now accounts for more than 40 percent of the total, leading all regions. According to UNCTAD, "strong domestic

Table 3-3

Summary of Total FDI Inflows to the Developing World, by Region, 1990 and 1995–2003 (US$ billion)

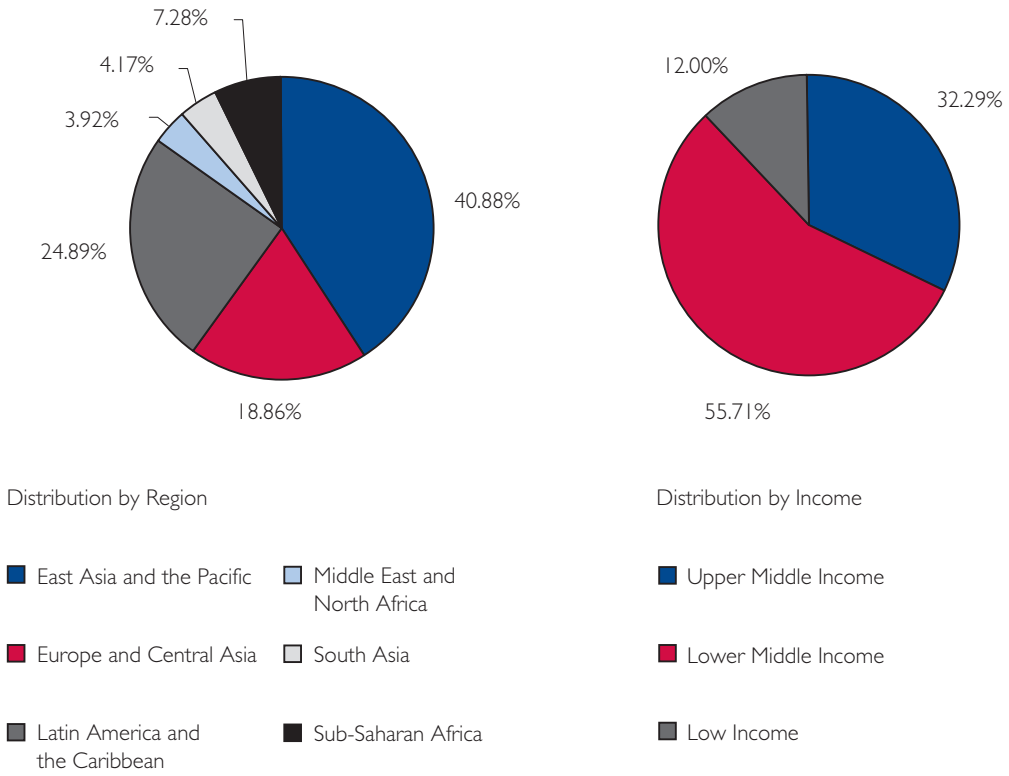
	1990	1995	1996	1997	1998	1999	2000	2001	2002	2003
Developing Countries	25.6	108.2	133.9	181.1	178.8	188.4	167.8	178.8	157.9	145.5
East Asia and the Pacific	11.2	54.4	62.7	65.7	60.6	52.5	46.5	51.1	60.7	59.5
(%)	43.7	50.2	46.8	36.3	33.9	27.9	27.7	28.6	38.4	40.9
Europe and Central Asia	1.3	17.7	17.3	24.6	28.0	29.7	30.2	32.8	35.2	27.4
(%)	4.9	16.4	12.9	13.6	15.7	15.8	18.0	18.3	22.3	18.9
Latin America and the Caribbean	8.6	29.6	45.7	71.2	72.5	91.6	79.6	70.5	45.6	36.2
(%)	33.4	27.3	34.1	39.3	40.6	48.6	47.5	39.5	28.9	24.9
Middle East and North Africa	2.8	-0.6	0.7	6.4	7.5	2.5	2.1	5.7	3.1	5.7
(%)	11.0	-0.6	0.5	3.5	4.2	1.3	1.3	3.2	2.0	3.9
South Asia	0.5	3.0	3.6	4.9	3.5	3.1	3.1	4.0	4.5	6.1
(%)	2.1	2.7	2.7	2.7	2.0	1.6	1.8	2.2	2.9	4.2
Sub-Saharan Africa	1.2	4.2	3.9	8.3	6.6	8.9	6.2	14.7	8.9	10.6
(%)	4.8	3.9	2.9	4.6	3.7	4.7	3.7	8.2	5.6	7.3

Notes: The category of developing countries consists of low- and middle-income countries according to World Bank classifications (2003 per capita GNI is $9,385 or below). Regional groupings are according to World Bank definitions. Based on these criteria certain countries that UNCTAD considers developing (e.g., Singapore, Hong Kong, Korea, Cayman Islands, Bermuda, Brunei, Barbados, Cyprus, Taiwan, Qatar, and UAE) the World Bank classifies as high-income.

SOURCES: UNCTAD, *World Investment Report 2004*; World Bank, *World Development Report 2005*.

Figure 3-3

FDI Inflows to the Developing World, by Region and Income Level, 2003



Notes: Developing countries are defined by World Bank criteria (per capita GNI for 2003 is US$ 9,385 or below). Based on these criteria, certain countries considered developed by UNCTAD (e.g., Singapore, Hong Kong, Korea, Brunei, Cayman Islands, Bermuda, Barbados, Cyprus, Taiwan, Kuwait, Qatar, and UAE) are classified as high income by the World Bank. Regions are defined according to World Bank classifications. Income groups are based on per capita GNI: low income, US $765 or less; lower middle income, US$ 766-3,035; upper middle income, US $3,036-9,385.

SOURCES: UNCTAD, *World Investment Report 2004*; World Bank, *World Development Report 2005*.

economic growth in key economies, improvements in the investment environment and regional integration that encourages intraregional investment and facilitates the expansion of production networks by transnational firms" are spurring FDI in Asia.[6] But after China, only Malaysia ($2.5 billion), Thailand ($1.8 billion), and Vietnam ($1.5 billion) attracted more than $1 billion in 2003—and for all three countries, these amounts are well below the FDI peak of 1996/1997.

Regional growth prospects are good, and the World Bank projects a 30 percent increase in FDI inflows over 2003 levels by 2005.[7] This projection assumes that present positive conditions continue: China further expands and liberalizes, Vietnam accedes to the WTO, Malaysia and Thailand further liberalize, and ASEAN strengthens regional integration. Because of China's vast market and cost advantages, manufacturing is likely to remain the lead attractor of FDI. In China and elsewhere in the region, investment in service subsectors is also expected to grow rapidly.

EUROPE AND CENTRAL ASIA—DESTINATION WITH A DIFFERENCE

Interactions with the European Union (EU) dominate this region, which captured $27 billion in 2003, about 19 percent of all developing country FDI inflows. This was a decline from the performance of 1998–2002. Over the last

five years, in the run-up to EU accession, Poland, Czech Republic, Hungary, and Slovakia together accounted for more than 50 percent of inflows. The dip in investment recorded in 2003 resulted largely from the completion of multiple privatizations before accession, with no new deals to replace them.

These countries remain attractive locations for FDI because of their low-wage, highly skilled workforce, low corporate tax rates, and new access to EU markets and subsidies. Given its size, Croatia has been an important FDI destination (see Table 3-2); and now that it is on track to join the EU it is likely to attract even more investment, much of it in real property. Russia, Central Asia, Kazakhstan, and Azerbaijan have all become important host countries, although the impact of the Russian government's recent dealings with the Yukos oil firm could greatly erode investor confidence.

On balance, increases in FDI inflows are projected for the region—World Bank forecasts show a 23 percent rise in net FDI by 2005 over 2003. Much of this may come from FDI in the oil sector. But some inflows will be efficiency-seeking investments as multinationals seize cost and location advantages and as mergers and acquisitions build on privatized assets.

LATIN AMERICA AND THE CARIBBEAN—PERSISTENT DECLINE

Between 1997 and 2001, this region captured more than 40 percent of FDI inflows to the developing world, eclipsing Asia. Since achieving an FDI peak of $92 billion in 1999, the region has experienced a continuous decrease in inflows, accounting for only 25 percent in 2003. Nevertheless, Latin America remains the second-largest regional recipient of FDI. Brazil, Mexico, and Argentina together accounted for more than 70 percent of inflows at the region's peak.

With a large manufacturing sector and extensive privatization in the service and financial sectors throughout the mid- to late-1990s, Brazil consistently received the largest share. But a weak economy (0.7 percent growth rate annually from 2001 to 2003), completion of several large privatizations in telecommunications and energy, and a general decline in mergers and acquisitions by multinationals, have cut Brazil's FDI inflows by two-thirds since 2000.

Mexico, the region's second-largest recipient, whose low-cost labor profile helped attract significant investment to manufacturing (54 percent of its national inflows), began facing strong competition for FDI from Asia and

Evolution of FDI in Developing Countries

Pre-1950. Two-thirds of FDI stock was in developing countries, especially Latin America and the Caribbean, and dominated by extractive and commodity-type investment.

1950–1970. Increase in flows between developed countries, especially across the Atlantic. Extractive and commodity FDI flows to developing countries continue, but with gradual rise of market-seeking manufacturing FDI. By 1970 developing countries represent one-third of global FDI stock.

1970–1990. Increasing focus on manufacturing investment in developing countries, but developing countries' share of global FDI stocks declines from 40 percent in 1985 to 25 percent in 1990.

1990–2000. Steady increase in volume of flow to developing countries is eclipsed by phenomenal rise in flows between developed countries. Service sector FDI flows to developing countries rise gradually to 40 percent of total FDI by 1999. Asia's (especially China and in manufacturing) and Latin America's (services and utilities) share also rises. Africa remains marginalized.

Three Global Variables in FDI Flows

Macroeconomic conditions. Over the past 30 years, peaks and valleys in world FDI have more or less coincided with global GDP growth. Good economic prospects raise confidence and stimulate investment of all kinds, including FDI. Past slumps in FDI inflows occurred in 1976, 1982–1983, 1991, and in 2000–2003. Real rates of global GDP increase fell at about the same time. The pattern appears tighter in the developed world than in the developing one. During periods of global economic stress, developed country multinationals seeking to cut costs continue to channel some FDI to developing countries.

Microeconomic forces. Movements in corporate profits affect FDI: in boom times, they provide resources and opportunities for FDI, and the reverse in bust periods. Lower corporate profits may also translate into declining stock market valuations for multinationals, in turn putting pressure on debt-equity ratios run up during economic expansions, and accelerating repayment of intra-company loans. This reduces FDI inflows. Lower equity values tied to stock market dips also discourage mergers and acquisitions.

Institutional factors. Privatization programs in the 1990s, especially in Latin America, Eastern Europe, and the Former Soviet Union, were a major institutional boost to FDI. Rapid rises in private participation in infrastructure in Asia were another. With the end of large privatizations and investors' reawakening to emerging market risk after the Asian Financial Crisis, both privatizations and infrastructure-related FDI dropped off sharply. See UNCTAD, *WIR 2003*, pp. 15-19. World Bank, *GDF 2004*, pp. 154-161.

Central America. Its FDI for 2003 was $11 billion, its lowest inflow since 1996. FDI inflows to Argentina have nearly vanished as a result of the country's December 2001 economic crisis: investment peaked at $24 billion in 1999 but is now a mere $500 million.

An expected upturn in economic growth in the region may fuel a recovery in FDI inflows over the next couple of years. But unfinished structural reforms to upgrade the investment climate, a lack of merger and acquisition opportunities, and stalled and politically unpopular privatizations could limit this region's prospects. This may be why the World Bank forecasts only a 6 percent rise in net FDI flows by 2005 over 2003.

MIDDLE EAST AND NORTH AFRICA—LAGGING BEHIND

With only $5.7 billion in FDI in 2003, this region has the lowest share of all inflows (4 percent). Continuing political instability, the Palestinian conflict, and the Iraq war have created risks that discourage FDI. But there are bright spots. Morocco completed a major privatization of its Régie des Tabacs (1.7 billion transaction) with Spanish and French investors in 2003. An end to 14 years of sanctions on Libya, together with the keen interest of U.S. oil firms in the country's petroleum resources, suggests significant potential for FDI inflows. And Algeria may have opportunities in oil and gas to attract FDI. The World Bank, however, projects no increase in FDI inflows to the region by 2005.

SOUTH ASIA—INDIA'S LEAD

In the past ten years this region has slowly built its FDI inflows to $6.1 billion, but this is still only slightly more than 4 percent of inflows to

the developing world. The growth is due almost entirely to India, whose inflows rose from $240 million in 1990 to $4.3 billion in 2003. India loosened restrictions on FDI in several sectors, including automobiles, telecommunications, financial services, and energy; and targeted FDI in information technology, such as software development and call centers. Pakistan is the only other important regional destination for FDI. Its inflows reached $1.4 billion in 2003, the highest ever, with investments in the financial sector and in oil and gas exploration. Given India's potential to attract FDI—its per capita inflows amounted to $4 in 2003, one-tenth the China standard—continuing growth in FDI inflows to the region is expected. The World Bank forecast for South Asia projects a 40 percent rise in net FDI flows between 2003 and 2005.

SUB-SAHARAN AFRICA—THE OIL FACTOR

This region comprises 47 countries; four of them account for 51 percent of FDI inflows to the region of $10.6 billion, 7 percent of developing country inflows. These four countries are oil exporters, actual or potential: Angola and Equatorial Guinea ($1.4 billion each), Sudan ($1.3 billion), and Nigeria ($1.2 billion). The next largest FDI recipient, Chad ($800 million), with its new pipeline is also an oil exporter. South Africa, the most developed and diversified economy, attracted $760 million in 2003 and is a major source of FDI outflows to the region. No other country captured more than $400 million in FDI, and most hosted annual inflows of less than $100 million.

Beyond the petroleum sector, this region's low labor productivity, poor infrastructure, poor policies, and political instability make its FDI potential uncertain. There are exceptions—Mozambique, Uganda, Ghana, Tanzania, Mauritania—where economic liberalization and opportunities in natural resources, light manufacturing and some services helped capture $200 to $300 million in FDI in 2003. Overall, FDI inflows have been volatile. The World Bank's forecast reflects this: net FDI flows are projected to increase over 2003 by 11 percent in 2004 and stay flat in 2005.

DISTRIBUTION BY COUNTRY INCOME LEVEL

FDI is often described as a capital source largely for middle-income countries, so that low-income countries should look elsewhere for financing for development. This generality could benefit from some distinctions (Table 3-4 and Table A-1 in Appendix A).

The 93 countries classified as "middle-income" received 90 percent or more of FDI inflows to the developing world throughout the 1990s through 2002, and in 2003 captured 88 percent (Figure 3-3). But when this category is divided into "lower middle-income" and "upper middle-income," it is clear that for most of the same period half or more of FDI flows were directed to economies with a per capita GNI of $3,035 or below (the ceiling for lower middle-income countries). This is a function of the importance of Southeast Asian lower middle-income economies—Thailand, Indonesia, Philippines—in attracting FDI inflows in the mid-1990s plus the growing dominance of China as an FDI magnet. The pattern was broken in the late 1990s by the wave of large-scale Latin American privatizations and mergers and acquisitions in services and banking, led by Brazil, Mexico and Argentina, all middle-income economies.

The poorest countries receive relatively little FDI. Using the UN's list of 50 "least developed countries" as the standard, the poorest economies have together hosted only between $3 billion and $7 billion in FDI inflows annually. But the trend for these countries is positive: in 2003 they garnered $7.4 billion, or more than 5 percent of developing country FDI inflows—their best performance ever. Oil exploration explains this rise, with petroleum sector FDI inflows to Angola, Chad, Equatorial Guinea, and Sudan amounting to $5 billion in 2003.

Table 3-4

Summary of Total FDI Inflows to the Developing World, by Country Income Level, 1990 and 1995–2003 (US$ billion)

	1990	1995	1996	1997	1998	1999	2000	2001	2002	2003
Developing Countries [a, b]	25.6	108.2	133.9	181.1	178.8	188.4	167.8	178.8	157.9	145.5
Middle income	23.5	99.5	123.5	167.6	166.7	175.6	157.9	165.1	144.3	128.0
(%)	91.6	91.9	92.2	92.5	93.3	93.2	94.1	92.4	91.4	88.0
Upper middle income	12.8	40.1	54.0	82.3	87.4	106.7	96.1	82.2	62.5	47.0
(%)	49.9	37.1	40.3	45.4	48.9	56.6	57.3	46.0	39.6	32.3
Lower middle income	10.7	59.3	69.5	85.3	79.3	68.9	61.8	82.9	81.8	81.0
(%)	41.7	54.8	51.9	47.1	44.4	36.6	36.8	46.4	51.8	55.7
Low income	2.2	8.8	10.5	13.5	12.1	12.8	9.9	13.6	13.6	17.5
(%)	8.4	8.1	7.8	7.5	6.7	6.8	5.9	7.6	8.6	12.0
For reference: UN LDCs [c]	0.6	1.7	2.2	3.4	4.5	5.7	3.8	6.5	5.8	7.4
(%)	2.3	1.6	1.6	1.9	2.5	3.0	2.3	3.6	3.6	5.1

[a] Represents low- and middle-income countries according to World Bank classifications (2003 per capita GNI is $9,385 or below). Based on these criteria, certain countries that UNCTAD considers developing (e.g., Singapore, Hong Kong, Korea, Cayman Islands, Bermuda, Brunei, Barbados, Cyprus, Taiwan, Qatar, and UAE), the World Bank classifies as high-income.

[b] Income groups are based on per capita GNI: low income, $765 or less; lower middle income, $766-$3,035; upper middle income, $3,036-$9,385.

[c] Least developed countries are 50 countries designated by the UN.

SOURCES: UNCTAD, *World Investment Report 2004*; World Bank, *World Development Report 2005*.

4. FDI DRIVERS AND FUTURE DIRECTIONS

In the developing world, macroeconomic forces, global production chains, technology advances, and host-country conditions determine volumes and locations of foreign direct investment. The result is a constantly shifting set of sectoral and industry destinations for FDI. But within these shifts, two clear trends have now emerged. First, in a break with the past, service sector activities now attract most FDI inflows, both globally and in developing countries. Second, as a group, developing countries have increased their share of total worldwide FDI stock in all sectors—primary, manufacturing, and services—but not in all industries within sectors. These trends, and the forces that drive them, combined with the end of the global system of quotas that has long distorted trade (and thus investment) in textiles and apparel, the dominance of China, and increasing "South–South" FDI, will shape the future of FDI in developing countries.

PRESENT PROFILE OF SECTORAL DESTINATIONS

Worldwide FDI patterns have shifted markedly over the past 15 years. Comparing the composition of inward FDI stock for 1990 and 2002, for the world and for developing countries, at the sectoral and then the industry level is revealing.[1]

SERVICES DOMINATE FDI

Foreign direct investment in services in developing countries increased substantially in the second half of the 1990s and at a faster rate than investment in manufacturing or natural resources. Here, services comprise the "old" services of conventional utilities, finance and insurance, and retail and wholesale distribution, and the "new" services of business support and other services enabled by telecommunications and information technology.

Within developing countries, services now represent more than half and manufacturing more than one-third of inward FDI stock. The natural resource sector's FDI stock has also grown in absolute terms, but its share (7 percent) of inward FDI stock is still much smaller (Table 4-1). This evolving sectoral composition parallels what has happened globally, where the concentration of FDI in services is even more pronounced (almost 60 percent) and the share of manufacturing even lower (33 percent).

There are clear regional differences in the buildup of service sector FDI in the developing world. In general, FDI for services has tended to flow to the wealthier upper-middle income economies—though there are exceptions (e.g., FDI in water services in Manila, Jakarta, or

Conakry). Services therefore loom largest in the FDI stock of Latin America and the Caribbean and of Europe and Central Asia. By contrast, in East Asia and the Pacific and in Africa, the major shares of inward FDI stock are in manufacturing and the primary sector, respectively (Figure 4-1). Such regional differences are logical: services grow in importance with rises in GDP; China is central to international manufacturing networks; and oil attracts the bulk of Africa's FDI.

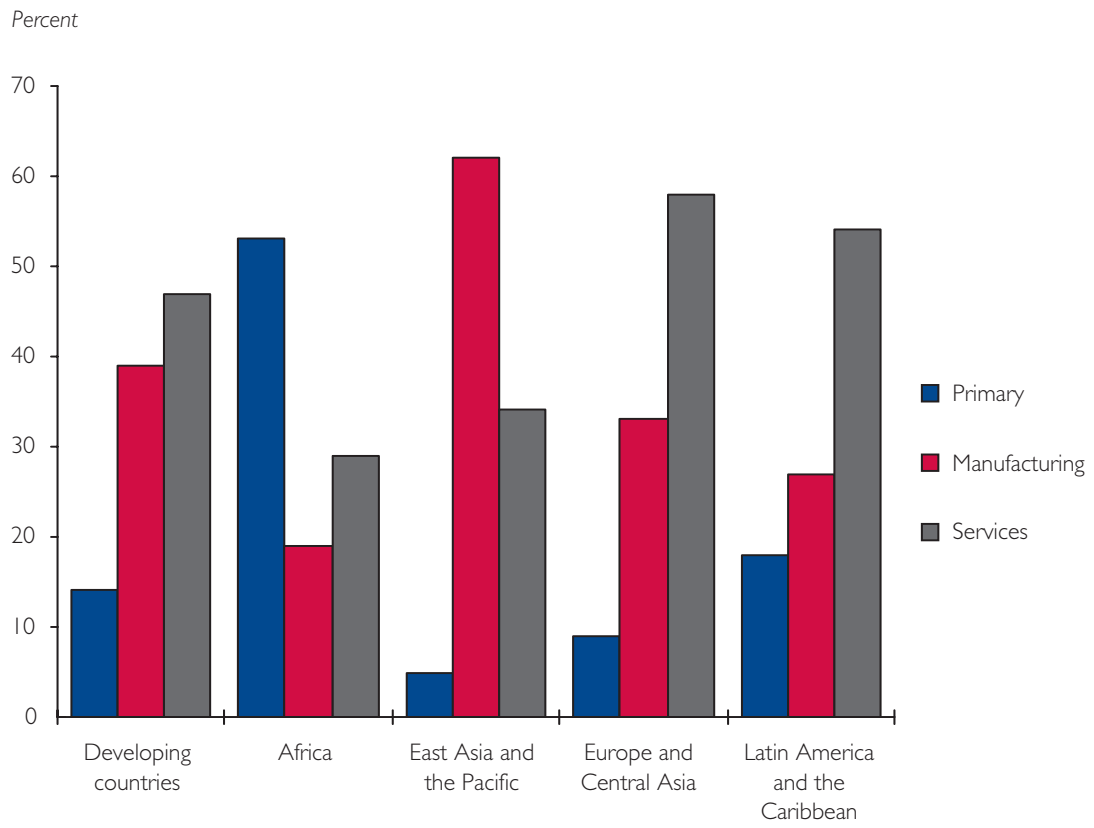
MIXED PICTURE OF DEVELOPING COUNTRY SHARE OF GLOBAL FDI

Developing countries together have increased their share of the world's inward FDI stock in all sectors, with the largest gains in primary activities and manufacturing (Table 4-1). But at the subsector level, changes in FDI patterns have been more complex, and may suggest trends for the future (see Tables A-2 and A-3 in Appendix A).

Dramatic growth in absolute value. For the 30 industries tracked by UNCTAD, the developing world increased the total *absolute* value of its inward FDI stock nearly six-fold between 1990 and 2002. Only one industry—publishing, printing, and reproduction of recorded media—experienced a decrease in absolute value of inward FDI stock.

Developing countries' manufacturing advantage not guaranteed in all industries. In the manufacturing sector as a whole, the absolute value of developing countries' inward FDI stock shot from $156 billion in 1990 to $750 billion in

Figure 4-1
Estimated Inward FDI Stock by Sector and Region, 2002



Note: May not add to totals due to rounding.

SOURCE: World Bank, *Global Development Finance, Hamessing Cyclical Gains for Development 2004*, p. 82.

Table 4-1

Sector Distribution of Inward FDI Stock in Developing Countries and Worldwide, and Developing Country Share of Worldwide Stock, 1990 and 2002

	Primary		Manufacturing		Services		Other/ Unspecified		Total	
	$[a]	%	$	%	$	%	$	%	$	%
1990										
Developing countries	23.1	6.7	155.9	45.1	163.3	47.2	3.6	1.0	345.9	100.0
Worldwide	182.5	9.4	806.9	41.4	948.1	48.6	12.8	0.7	1,950.3	100.0
2002										
Developing countries	144.8	7.0	750.2	36.4	1,098.5	53.3	69.2	3.4	2,062.7	100.0
Central and Eastern Europe	6.9	2.9	90.4	37.5	134.8	55.9	9.0	3.7	241.1	100.0
Developing countries (adj.)[b]	151.7	6.6	840.6	36.5	1,233.3	53.5	78.2	3.4	2,303.8	100.0
Worldwide	448.9	6.1	2,442.6	33.1	4,363.4	59.2	116.7	1.6	7,371.6	100.0
Developing Country Share of Worldwide Stock (%)										
1990										
Developing countries	12.7		19.3		17.2		28.1		17.7	
2002										
Developing countries	32.3		30.7		25.2		59.3		28.0	
Central and Eastern Europe	1.5		3.7		3.1		7.7		3.3	
Developing countries (adj.)[b]	33.8		34.4		28.3		67.0		31.3	

[a] Billions of US dollars.

[b] Sum of developing countries and Central and Eastern Europe.

SOURCE: UNCTAD *World Investment Report 2004*, Annex Table A.I.18.

2002, an increase of nearly 400 percent. (If the manufacturing stock of transitional economies is added to the stock of those countries counted as "developing" in 1990, growth even exceeds 500 percent.) However, since 1990 they have actually lost share in world FDI stock in some manufacturing industries while gaining in others. This underlines the fact that developing countries do not have an across-the-board advantage in attracting FDI to manufacturing—despite their low-cost labor.

Expanding opportunities in services. Since 1990, developing countries have increased their ***share*** of world inward FDI stock in five of seven service industries monitored by UNCTAD. This means that the rate of increase in FDI flows to the developing world in these services has outstripped that of the developed countries. These gains are particularly striking in construction, retail and wholesale trade, hotels and restaurants, and especially in business services such as accounting, consultancy, marketing, and advertising.[2] Additional increases were achieved in power and water subsectors. In transport, storage and communications, as well as finance and insurance services, developing countries increased the value of inward FDI stock while their shares of world FDI stock actually decreased. This means that the relative attraction of FDI targets in these "older service" industries has been even stronger in the developed world

Armenia's IT Industry—Guns to Software in the Former Soviet Union

Deep in the Caucasus, with a population of 3 million and a per capita income (GNI basis) of $950, Armenia has entered the global information and communications technology industry. On the basis of its strong education system and excellent research institutions, Armenia was once the socialist world's Silicon Valley, and by 1990 was supplying 30 percent of the Soviet defense and space industries' computer equipment. Now beginning to capture efficiency-seeking FDI, Armenia's IT sector is still its star performer, growing 20–25 percent annually with current production valued at $50 million, most exported; and employing 3,500 to 5,000, with jobs increasing at 20 percent per year. Exportable IT services is a leading-edge industry: customized applications development and embedded software for now, with business process outsourcing and other activities to follow. Vital to this growth is Armenia's highly skilled, low-cost technical workforce. Average wages for software development are 90 percent lower than those in the United States, and roughly one-third to one-seventh of those in India for comparable skills. These ratios have attracted FDI in the last five years. Armenia's IT industry is now dominated by foreign investors, with US-sourced FDI accounting for 65 percent of industry investment. Skilled IT professionals in the diaspora have helped promote these efficiency-seeking FDI opportunities and brought Armenia into the global IT production network.

SOURCE: Armenia Development Agency, McKinsey and Co., Armenia 2020 Project.

than in the developing one—at least for now, because with China's liberalization of finance and logistics in 2005, the door will open to vast new opportunities for FDI in such older services.

Appeal of Eastern and Central Europe. The emergence of industries in some former socialist countries as possible FDI destinations has reshuffled global FDI inflows. Data for Central and Eastern Europe for 2002 show that industries in these transition economies—largely absent from world FDI flows in the pre-1990 socialist era—have become appealing destinations for worldwide FDI in certain manufacturing industries. Among these are food, beverages and tobacco; wood and wood products; rubber and plastics; and automobiles and transport equipment. The power of this appeal is underscored by a cross-border automotive industry cluster that comprises 13 automobile plants, 10 power train factories, and hundreds of suppliers in a 500-km circle encompassing parts of the Czech Republic, Hungary, Poland, Slovakia, and Slovenia.[3] Since the fall of the Berlin Wall, these transition economies have also attracted FDI in textiles, clothing and leather, machinery and equipment, electrical and electronic equipment, utilities, construction, and transport, storage, and communications.

All the shifts in the composition of FDI stocks just described may denote "level shifts"—permanent changes in the pattern of FDI that the developing world will most readily attract. How then do these new patterns translate into overall future direction for FDI?

SERVICES FDI—LONG-TERM GROWTH

The steadily growing allure of services is the most important trend in foreign direct investment in developing countries. The shift from

manufacturing to services as FDI's leading sectoral destination is fundamental, and can only accelerate and intensify. The build-up of investment in services derives partly from the rising importance of services in all economies. But closer examination of two categories of services shows other forces at play.

NON-TRADABLE SERVICES—MARKET-SEEKING FDI

"Non-tradables" are services that must be produced and consumed in the same location. FDI inflows to these services are therefore market-seeking. Such market-seeking FDI has increased. Utilities, finance, and especially construction, hotels and restaurants, retail and wholesale trade, and transportation are prime industry destinations for such market-seeking investment. Developing country FDI stock in these service industries has risen rapidly, at a pace exceeding that of FDI in the developed world in all but finance and transport (Figures 4-2 and 4-3).

Traditionally, FDI in banking, insurance, and transportation was often the result of service providers supporting the foreign operations of existing (manufacturing) clients. This trend may be losing momentum. It appears that providers of non-tradable services may now be investing internationally to reach foreign markets independent of existing clients. High-growth prospects in these markets will continue to be the principal driver for such investment, along with liberalization of market entry and regulation, especially the loosening of restrictions on foreign ownership and pricing. Privatization, which has turned many out-of-bounds utilities into commercial enterprises, will continue to be an essential ingredient. Foreign investors also see advantages in diversifying sources of revenue and profits; corporate risk diversification can spur FDI in new markets—particularly as those markets become more accepting of and hospitable to foreign service providers making equity investments.

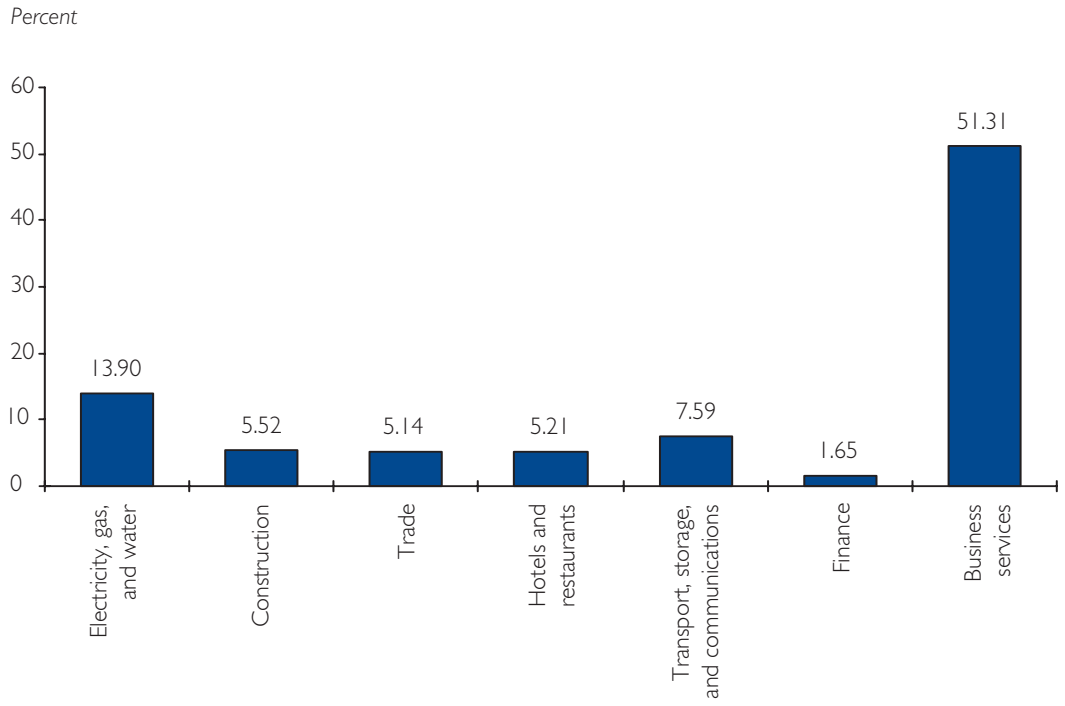
Market-seeking activities account for the biggest portion of service-oriented FDI, and these inflows are expected to continue growing as new markets open. China will present the most dramatic opportunities, given its WTO commitments to free most services for majority foreign ownership by the end of 2005. India, where service sector liberalization is still gathering momentum, will be another.

TRADABLE SERVICES—EFFICIENCY-SEEKING FDI

More and more services that were once location-bound and non-tradable have become "tradable" thanks to information technology. These include business support activities such as accounting, recordkeeping, drawing, testing, audiovisual services, and even research and development. For all, information technology has permitted knowledge to be codified, standardized and digitized, and then sent anywhere at very little cost. Service providers, applying the model for international manufacturing production networks, are now splitting their products into components and distributing them around the world according to the comparative advantages of locations.[4]

Thus, service-oriented FDI flows can now be efficiency-seeking in at least three different models. First, firms can offshore internal intra-firm services (e.g., manufacturing firms in developed countries can use FDI to create foreign affiliates in low-cost locations to provide services to the parent enterprise). Second, independent service provider firms—lawyers, accountants, engineers, consultants—can also offshore, and through FDI set up facilities in foreign markets to support traditional clients more cost-effectively from or in those same foreign locations. And third, suppliers of tradable services for export (such as data processing or call centers) can invest internationally to take advantage of good information and communication technologies and skilled, inexpensive workforces. In all cases the goal is to rationalize global operations to obtain and/or produce services for clients in home countries or around the world at the lowest cost.

Figure 4-2
Selected Service Industries: Growth in Value of Developing Country Stock of FDI, 1990–2002



Note: Does not include the value and share of Central and Eastern Europe FDI stock.

SOURCE: Appendix A, Tables A-2 and A-3.

UNPARALLELED FUTURE EXPANSION

Efficiency-seeking FDI in services is likely to outstrip and outpace past increases in efficiency-seeking FDI in manufacturing. Services are involved in a vast number of industries in all sectors, while efficiency-seeking in manufacturing affects only that sector. And technology continues to raise the limits of what is possible in knowledge management. The exponential growth expected already has been evident in business services FDI since 1990 (Figure 4-2).

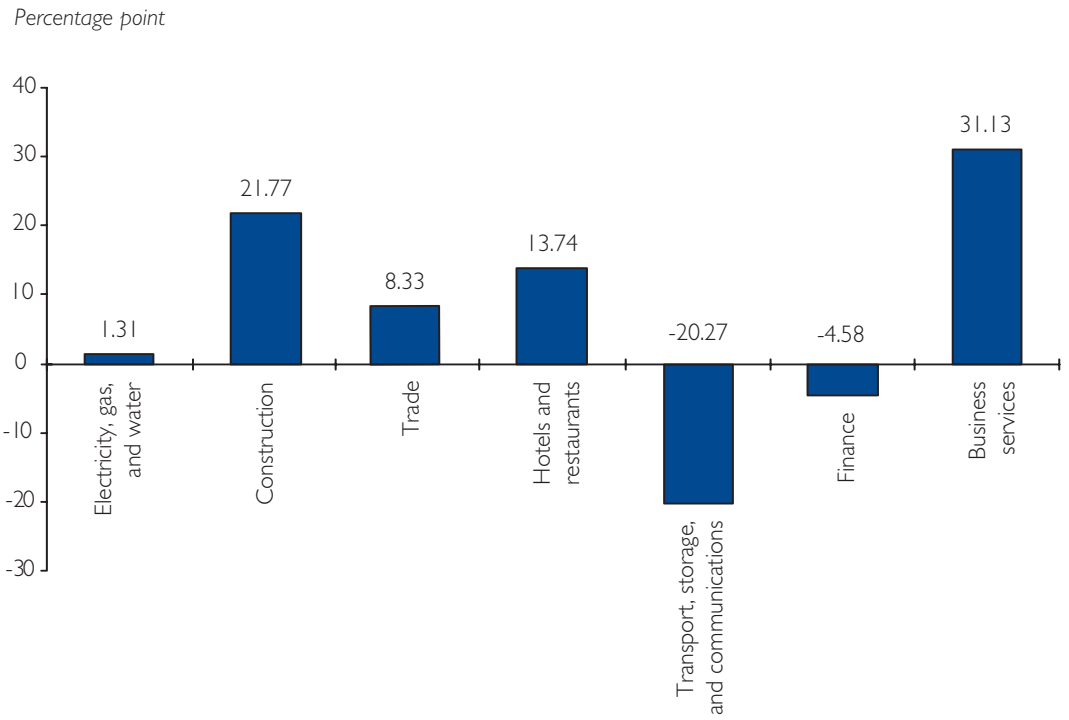
In the past, services-oriented FDI occurred because companies *had* to invest abroad to support local customers. In the future, such investment will express parent companies' competitive strategies, and FDI inflows will follow the latest and best opportunities for cost-efficiency that foreign destinations can promise. From the perspective of developing countries, the offer of skilled labor, quality infrastructure, political and economic stability, and effective regulatory systems—the variables of cost-efficiency—will drive these future service-oriented FDI inflows.

MANUFACTURING FDI—TECHNOLOGY-BASED FUTURE

Manufacturing will continue to attract FDI to developing countries but will be less dynamic. This trend is already evident in a review of industry changes in FDI stock. For example, between 1990 and 2002, developing countries increased their share of world inward FDI stock in the manufacture of food, beverages, and tobacco; wood and wood products; coke and petroleum products; machinery and equipment; electrical and electronic equipment; and precision instruments. But they lost share of global inward FDI stock in other activities: textiles,

Figure 4-3

Selected Service Industries: Loss and Gain in Developing Countries' Share of World FDI Stock, 1990–2002



Note: Does not include the value and share of Central and Eastern Europe FDI stock.

SOURCE: Appendix A, Tables A-2 and A-3.

clothing, and leather; chemicals and chemical products; rubber and plastics; non-metallic mineral products; metal and metal products; and automobiles and transport equipment. (This trend does not count the manufacturing-related FDI stock of Central and Eastern Europe's transitional economies). This loss of share occurred even as the value of developing country stock in these industries increased (Figures 4-4 and 4-5).

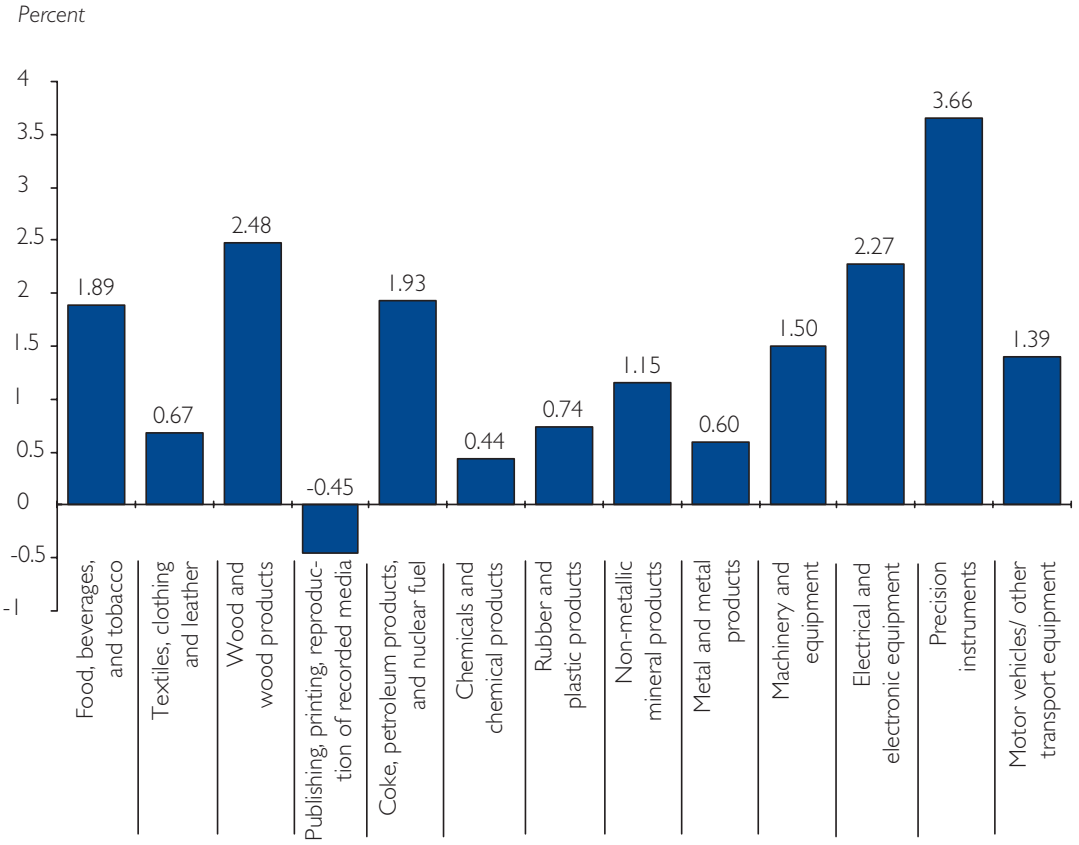
FUNDAMENTAL CHANGE IN MANUFACTURING

The mixed results outlined above are rational. Manufacturing is a mature sector for FDI in the developing world, where many opportunities—driven by the desire for efficiency—have already been realized. But shifts may be due even more to a change in the fundamentals of manufacturing.[5] The decline in labor-intensive manufacturing, for example, explains the loss of developing countries' share of FDI in textiles or automobile production, as well as the absolute loss in FDI inward stock in publishing, printing, and reproduction of recorded media.

In such industries, production is increasingly technology-intensive, with capital and knowledge assets replacing labor. In a modern automobile plant, for example, a few workers monitor a highly automated production process while others are engaged in purchasing, inventory, logistics, and finance. This kind of manufacturing, coupled with the disaggregation of value chains, means that many manufacturing activities have begun to look like services, reinforcing the shift to services described earlier. Accordingly, the appeal of low-cost labor in developing countries is diminishing.

Figure 4-4

Selected Manufacturing Industries: Growth in Value of Developing Country Stock of FDI, 1990–2002



Note: Does not include the value and share of Central and Eastern European FDI stock.

SOURCE: Table 4-2 and Appendix A, Table A-2.

IMPLICATIONS FOR THE "LADDER EFFECT"

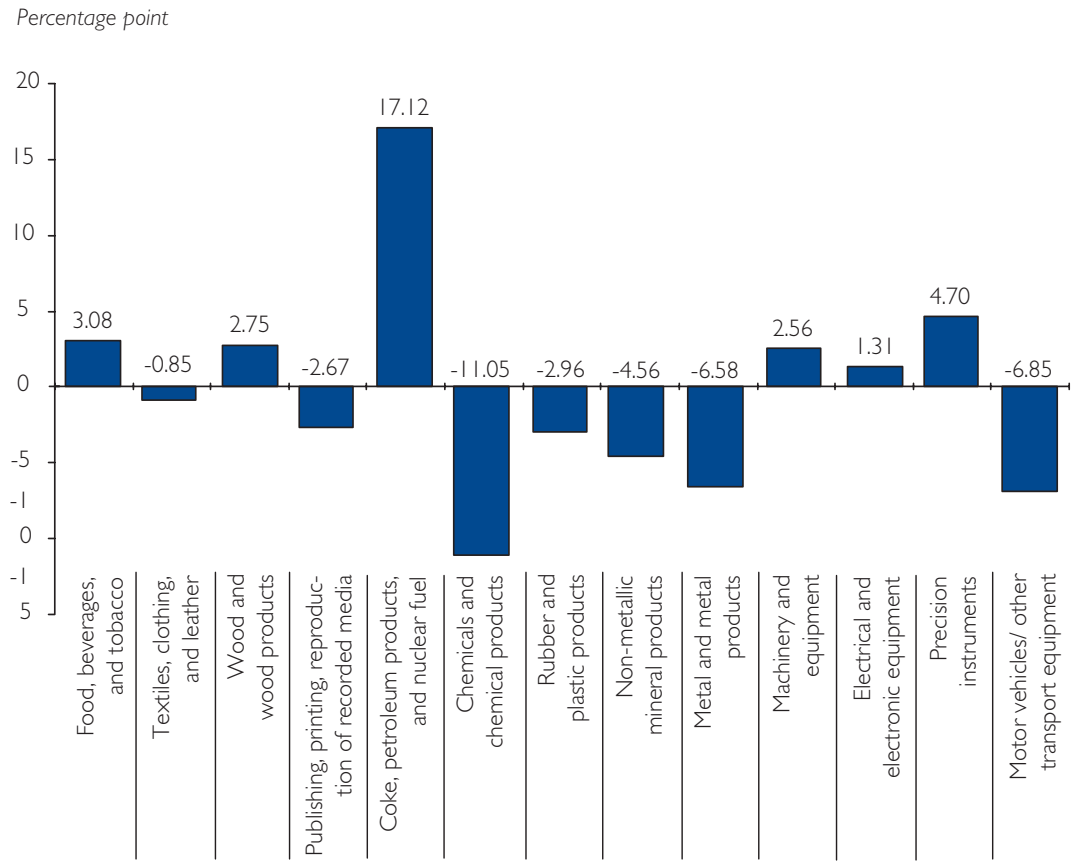
For developing countries, the implications of changes in manufacturing are twofold. First of all, the "ladder effect" for channeling FDI flows will continue to operate, but more rapidly and perhaps with more rungs at the top than the bottom. Movement in the global pecking order for FDI will be constant, as countries cost themselves out of simpler, lower-tech manufacturing and move up to more sophisticated, knowledge- and capital-based activities, leaving the former to other FDI destinations that are still cost-effective. With the rapid pace of technological advance, lower-tech manufacturing opportunities will dwindle as high-tech opportunities increase, giving countries an incentive to climb the ladder and attract technology-based manufacturing FDI. Additionally, as always, at the bottom, top, and middle of the ladder, host countries will need to develop targeted packages of skills, costs, institutions, and policies to compete for manufacturing FDI.

FUTURE FDI DIRECTIONS—OTHER DRIVERS

The forces at work in services and manufacturing are broad-based, long-term determinants of the physical and sector destinations of FDI in the developing world. But three more narrowly focused factors will also drive future patterns in FDI: the phase-out of global textile quotas, the

Figure 4-5

Selected Manufacturing Industries: Loss and Gain in Developing Countries' Shares of World FDI Stock, 1990–2002



Note: Does not include the value and share of Central and Eastern European FDI stock.

SOURCE: Table 4-2 and Appendix A, Table A-2.

enduring appeal of China as a destination, and South–South flows of investment.

THE END OF GLOBAL TEXTILE QUOTAS

Apparel is a special case in the future of manufacturing FDI. For nearly half a century, developed countries regulated access to their textile and apparel markets with import quotas, tariffs, and systems of preferential access. The Multifibre Arrangement (MFA) was the principal mechanism of control. While the agreement restrained imports from many low-cost producers such as China and India, it encouraged investment in the apparel sectors of low-wage countries that had not filled their quotas and that, in effect, enjoyed a guaranteed level of access to U.S. and European markets. Quota access reinforced by low wages became a powerful lure for FDI in the apparel sector, which can establish, uproot, and reposition facilities quickly and cheaply. Many U.S., European, and Asian textile and clothing manufacturers responded by setting up operations in Mauritius, Lesotho, the Caribbean, Cambodia, Mongolia, and other locations that otherwise had no textile or apparel industry.

But the system has changed radically: the WTO Agreement on Textiles and Clothing, in operation since 1995, ended the MFA and eliminated quotas on January 1, 2005. Many developing countries that had benefited from quota restraints on their toughest rivals will now be

China's FDI History and Characteristics

1949–1978. Expropriation of foreign assets at Communist assumption of power in 1949. Very limited foreign investment, mainly from Hong Kong and Macao. No company law; no law on foreign investment.

1978–1990. China begins economic reform and opening up policy. Four Special Economic Zones near Hong Kong and Macao are permitted to host foreign investment, using preferential tax, employment, and other incentives. Laws on foreign investment, together with implementing regulations, are enacted. Many requirements are imposed on foreign companies to transfer technology, balance imports with exports, meet minimum local-content and export obligations. Fourteen coastal cities and 10 provinces present opportunities, and Western European, Japanese, and American companies recognize potential, though overseas Chinese still account for the majority of FDI inflows. Many large multinational corporations whose assets were seized in 1949 return to China. FDI dips in 1989 because of political events in Tiananmen Square.

1990s–Present. To restore investor confidence in the continuation of China's economic reform and opening policies, paramount leader Deng Xiaoping, despite ailing health, travels to the largest Special Economic Zone. FDI flows recover quickly. China privatizes some state-owned enterprises, allows sale of stock, including in Hong Kong stock market, of others. Initiatives encouraging FDI in the interior provinces are launched, though investors are slow to respond because of infrastructure, worker, and managerial difficulties. China accedes to the World Trade Organization in 2001 and pledges to open up sectors to foreign investment, including majority foreign equity, and to dismantle export and foreign exchange balancing/local content requirements long imposed on foreign investors. Annual FDI inflows soar to $53 billion in 2003.

competing for markets in the United States and the European Union on the basis of price, quality, and responsiveness to market demand.

How will the elimination of quotas affect FDI inflows? As quota access becomes irrelevant to plant location, many developing countries will lose investment in textile and apparel manufacturing, much of which had come from China. Countries such as Cambodia (textiles and clothing comprise or equal 84 percent of export value), Bangladesh (74 percent of export value), Mauritius (57 percent of export value), and the Dominican Republic (51 percent of export value), whose textile and clothing industries have depended largely on quota restrictions on low-cost Asian producers, could face rapid disinvestment. The major beneficiary of quota elimination will be China. Although not the lowest-cost producer, China is extremely efficient because of its massive economies of scale and it offers a production volume, reliability, and responsiveness that will allow it to dominate the textile and apparel industry.

The textile and clothing industry, however, will seek some diversification of supply beyond China, especially among producers who modernize, ensure quality, and provide special advantages. FDI might still flow, for example, to countries like the Dominican Republic, which offers just-in-time inventory advantages for the U.S. market, or to Croatia, which produces high-end specialty apparel for the EU market.[6] Ultimately, other than China, some other large-scale, low-cost producers will probably attract

much of future FDI for such manufacturing away from countries like Cambodia, Mongolia, and Lesotho. Even before quotas were eliminated, production and related investment had already begun shifting to such producers, including India, where wages average $0.70 per hour versus $0.92 in China.[7]

CHINA, THE FDI MAGNET

China became the world's largest recipient of FDI in 2003. The FDI sources for China are wide and deep, and are led by Hong Kong and others from the Newly Industrialized Economies (NIE). Japan, the United States, and other OECD investors are also important. The array of industry destinations for China's FDI is also impressive. The manufacturing sector still dominates inflows, claiming 74 percent in 2003. Relatively labor-intensive industries (e.g., food processing, clothing, and sports goods) make up half of China's FDI, both for the host market and for export. Global firms such as Ericsson, Intel, Philips, and Toshiba have substantial investments in capital- and technology-intensive production in information and communication technology (ICT) activities. China attracted service sector inward FDI totaling $13 billion in 2002. Most FDI in services is still market-seeking—finance, telecommunications, and wholesale and retail commerce—and is expected to grow.

Why does China attract so much investment? First, its vast and increasingly prosperous domestic market promises high rates of return even on investments with long time horizons. Second, it has an enormous, low-cost, well-trained, and highly productive workforce and universities capable of honing the technical skills necessary for industrial activities such as research and development. China's labor resources are difficult for other countries to match at competitive prices. Third, China's accession to the WTO in 2001 enhanced the competitiveness of foreign and domestic Chinese companies in overseas markets. This competitiveness has been reinforced (at least for now) by China's decision not to revalue its fixed exchange rate against the U.S. dollar despite pressure from its competitors to do so. Finally, China promotes investment in sectors strategically important to its economy, and its investment climate is welcoming to FDI, featuring tax rules that favor FDI and formal government endorsement of special economic zones, including 15 currently operating export processing zones. Consequently, China has become and will continue to be the developing world's premier FDI destination, with a powerful pull for both market-seeking and efficiency-seeking FDI.

Future opportunities for both kinds of FDI will continue to unfold. In per capita terms, China's FDI inflows amount to $40—less than that of OECD countries and many developing countries—and those inflows are not evenly distributed by region. FDI in the western provinces continues to lag far behind the coastal regions, and while the government's *Xibu Da Kaifa* (Great Westward Development) campaign has built up infrastructure, growth in FDI to that region has not yet materialized. The state-owned enterprise sector has also had some inward FDI, but not a dramatic amount.

Given China's assets and opportunities, robust growth, and a healthy world economy, the roughly 7 percent annual average rate of increase in FDI that China has experienced over the last decade may still extend into the future.

SOUTH–SOUTH FLOWS

A new trend of particular relevance to developing countries may be emerging. According to a survey of inflows and outflows in a sample of developing countries, South-based multinational corporations became more active in FDI flows during the 1990s. Although developed countries continue to provide the predominant share of FDI capital, the share of South–South FDI inflows peaked in 2000, when they accounted for about a third to developing countries, up from 17 percent in 1995. Since then these flows have diminished, perhaps as part of the general slump in global FDI (Table 4-2).

Table 4-2

Estimated FDI Flows to 30 Developing Countries, by Source, 1995–2001(US$ billion)

	1995		1996		1997		1998		1999		2000		2001	
Source	($)	(%)	($)	(%)	($)	(%)	($)	(%)	($)	(%)	($)	(%)	($)	(%)
All	92.5	100.0	111.0	100.0	145.1	100.0	145.1	100.0	155.2	100.0	141.8	100.0	146.8	100.0
High-income countries	77.2	83.5	85.7	77.2	89.1	61.4	91.8	63.3	108.4	69.8	93.2	65.7	106	72.2
OECD	50.7	54.8	58.6	52.8	69.9	48.2	71.6	49.3	89.9	57.9	83.3	58.7	83.5	56.9
Non-OECD	26.5	28.6	27.1	24.4	19.2	13.2	20.2	13.9	18.5	11.9	9.9	7.0	22.5	15.3
Developing Countries	15.3	16.5	25.3	22.8	56.0	38.6	53.3	36.7	46.8	30.2	48.6	34.3	40.8	27.8

SOURCE: World Bank, *Global Development Finance, Harnessing Cyclical Gains for Development 2004*, Volume 1, p. 81.

China and South Africa both appear to be significant sources of FDI in sub-Saharan Africa. In the 1990s, for example, Chinese investment was driven largely by the desire to use "quota-rich" African countries as production platforms for apparel destined for the U.S. and EU markets. But China's FDI activity may also reflect a government policy of outward investment to offset foreign exchange reserves increasing rapidly under the *renminbi* fixed dollar peg. Russia is also reported to be a source of FDI throughout the former Soviet Union, particularly in natural resources and transport.[8]

As FDI flows expand with general improvement in the world economy, the rise of South–South FDI could be a promising phenomenon for developing countries. Investors based in developing countries may be better equipped to operate in and bear the risk of other emerging country markets, thus multiplying the potential sources of FDI for the developing world. Further, such FDI could lead to production of goods and services particularly well adapted to local tastes and price preferences. If so, this could encourage additional South–South FDI outflows and inflows.[9]

5. ATTRACTING FDI

In 2005, developing countries face two fundamental facts about foreign direct investment: (1) FDI can spur development and (2) competition for it is fierce. No fewer than 164 national investment promotion agencies (IPAs) exist worldwide, and another 250 operate at a subnational level. And competition for FDI can only intensify given China's powerful appeal and India's potential to attract substantially more FDI. Given these facts, policymakers and businesses in the developing world, particularly in countries with no overwhelming natural advantages for foreign investors, ask, How can we attract FDI? The answer, improve the investment climate; then promote investment.

WHAT FOREIGN INVESTORS WANT—FDI'S DETERMINANTS

As detailed in Chapter 2, the motives of multinational firms in undertaking foreign investment are realized through four types of investment:[1]

- ***Natural resource-seeking FDI*** for mineral and petroleum resources, and often forestry, agricultural, and other natural assets;
- ***Market-seeking FDI*** for new customers and clients that can be best served by locating production in foreign markets rather than by exporting;
- ***Efficiency-seeking FDI*** for cost-productivity improvements that lower the cost of production within global production networks; and
- ***Strategic asset-seeking FDI*** for very specific tangible or intangible assets that complement the multinationals' asset base.

Of course, translating these motives into concrete decisions to invest in a given location depends on an array of other variables, many peculiar to sectors, industries, or the characteristics of individual projects. But, as surveys of foreign investors demonstrate over and over again, some common factors also determine where multinationals ultimately invest.[2] These factors include basic commercial-economic issues and trends that affect all investment decisions, with some twists for FDI:

- For market-seeking foreign investors, market size, growth, and opportunities for expansion through regional trade agreements;
- For efficiency-seeking foreign investors, the availability of skilled and unskilled labor at wage rates commensurate with productivity, as well as other cost-effective production inputs; and
- For natural resource-seeking foreign investors, abundant natural resources, accompanied by an ample supply of unskilled labor.

In addition to these commercial-economic issues, multinationals pay close attention to political, institutional, and regulatory characteristics that together define a host country's "investment climate."

BACK TO BASICS—THE RIGHT INVESTMENT CLIMATE

A country's investment climate is the sum of its public policy and institutional characteristics and conditions that affect the attractiveness and profitability of establishing and operating a business. As the World Bank has said, "Governments influence the investment climate through the impact of their policies and behaviors on the costs, risks, and barriers to competition facing firms."[3] A healthy economic regime requires getting the investment climate right. Doing so benefits all investors—foreign and domestic alike. A sound investment climate not only attracts foreign direct investment, but also figures heavily in domestic investors' decisions to establish or expand their businesses.[4] Moreover, there is ample empirical evidence that differences in productivity in both FDI and domestic investment can be explained by differences in investment climate, including good governance, institutions, and government policies.[5] With distortions and inefficiencies that erode productivity removed, a sound climate boosts the quality of all investment in addition to encouraging capital accumulation. This is especially valuable in making the most of FDI.

WHAT IS "RIGHT"?

The investment climate is composed of three elements: conditions of macroeconomic stability (including policy predictability); the microeconomic enabling environment; and the infrastructure base. A multinational takes all three into account, so that getting the investment climate "right" means making policy and institutional reforms in each area.[6]

For example, a sound investment climate requires macroeconomic stability and institutional predictability. The famed "Washington Consensus" set forth reform prescriptions for ensuring this result. Such reforms establish competitive exchange rates and market-determined interest rates; fiscal discipline, efficient tax systems, and prudent public expenditure and debt management; and privatization, deregulation, and general recognition of property rights. Liberalization of trade and FDI policy is also part of the reform package.[7] Many experts now agree that while macroeconomic stability and institutional predictability are necessary to attract FDI and are achievable through such reforms, they are not sufficient.

This is why the right investment climate also features an enabling environment at the microeconomic level. Microeconomic factors affect the way individuals or firms operate in the macroeconomic environment. These factors are key to project profitability and thus to attracting FDI.[8] A positive enabling environment is characterized by

- ***Good governance,*** maximized through transparency and the rule of law, including a range of specific investor protections to secure and safeguard private property and preserve the sanctity of contracts, as well as measures to minimize crime;
- ***Openness to trade,*** achieved by liberalizing foreign trade policy, but also by removing administrative barriers to entry and exit in domestic markets, ending state monopolies, and generally promoting competitive conditions;
- ***Minimal distortions,*** created by lowering tax rates and eliminating arbitrary regulation and overregulation, and especially by reducing the administrative "red-tape factor" in doing business. This allows and encourages individuals (e.g., upstream suppliers for foreign affiliates) to start their own businesses and to use their land and property as collateral to raise cash and obtain credit. For FDI, embracing the principle of non-discrimination between foreign investors and domestic investors is particularly important.

Finally, reliable, cost-effective infrastructure is critical to a favorable investment climate. Foreign investors repeatedly identify physical infrastructure—power, water, transport—as the most important determinant of a decision to invest, with cost of utilities running a close second.[9] Technological infrastructure, especially information and communications technology, is also a determinant.[10] Moreover, widespread basic education and public health systems, both essential to workforce development and health, are fundamental to a good investment climate.[11] Together, all these elements create a "virtuous circle" in which improvements in infrastructure lead to efficiencies that attract more investment, thus expanding the service base that makes infrastructure even more cost-effective for business.

ASSESSING THE INVESTMENT CLIMATE

Governments seeking to attract FDI can begin improving the investment climate by assessing current conditions using a number of tools (Table 5-1).[12] Potential investors also consult these tools, which range from highly aggregated indexes to very narrow country- or industry-specific analyses of institutional corruption. The World Bank maintains a list of sources of investment climate indicators at www.fias.net/investment_climate.html. Two of these tools especially address microeconomic factors:

Doing Business Database. Co-sponsored by the World Bank and the International Finance Corporation, this database is a relatively new source of indicators of business climates. Its thoroughness and data collection methodology are highly regarded.[13] Started in 2003 and in the spirit of work by Hernando de Soto and the "investor roadmap" that USAID helped develop in the early 1990s, the database compares the regulatory costs of doing business across 145 countries on the basis of seven indicators:[14] starting a business, hiring and firing workers, registering property, enforcing contracts, getting credit, protecting investors, and closing a business. In late 2005, the database will also cover trade logistics, corporate taxation, licensing, and inspections. The database is accessible at rru.worldbank.org/DoingBusiness/.

Global Competitiveness Index (GCI). Created by the World Economic Forum (WEF), this index first appeared in 2004 and will eventually consolidate WEF's macroeconomic Growth Competitiveness Index and its microeconomic Business Competitiveness Index. The new GCI is an aggregate measure of the investment climate relying on 12 pillars of competitiveness, organized by basic requirements, efficiency enhancers, and innovation factors. It provides a comprehensive view of the investment climate of 103 countries and is expected to increase to at least 135 countries by 2007. The WEF index and other investment-related information are available at www.weforum.com.

IMPROVEMENT MEASURES

Creating the right investment climate is a perpetual process, since no country's macroeconomic conditions, microeconomic factors, and infrastructure systems are perfect, and technological progress constantly poses new opportunities and requirements for reform. But many governments have embraced the principle that upgrading the climate is a foundation for economic growth and development and a prerequisite for capturing FDI.[15]

In improving the investment climate, governments in developing and developed countries alike tend to concentrate on three kinds of efforts. First, they may seek to lower costs, risks, and barriers to competition through pragmatic across-the-board microeconomic reforms related to, for example, taxes, property rights, and business-related approval procedures (Table 5-2). Such initiatives may be general or sector-specific, and may require cooperation among national, provincial, and municipal governments. Second, they may introduce or upgrade special investment regimes to establish an attractive sub-climate within the economy for FDI-based firms alone.

Finally, they may enter into international or regional trade or investment accords that can

Table 5-1
Characteristics of Selected Investment Scoreboards

Name and Current Country Coverage	Topical Coverage	Information Sources	Latest Survey Data
Investment Compass (UNCTAD)—52 predominantly poorer countries in Africa, Asia, and Latin America	Regulatory framework, public governance, human capital, raw materials, infrastructure, operating costs, market size, macroeconomic performance	Macro/microeconomic data supplemented by existing surveys	2004
World Business Environment Survey (World Bank)—80 predominantly developing and transition countries	Public services, public policy, legal system, corruption, regulation, competition, financial services	Survey of national enterprises	1999-2000
Business Environment and Enterprise Performance Survey (World Bank and EBRD)—27 transition countries	Business regulation, competition and concentration, corruption, influence and lobbying, infrastructure, labor market, rule of law, financial system	Survey of national enterprises	2002
Doing Business (World Bank)—145 countries	Costs and procedures when starting a business, hiring and firing, seeking credit, enforcing contracts, closing a business; additional countries and indicators to be added in 2005 and in future years.	Local experts	2004
Global Competitiveness Index (World Economic Forum)—103 countries	Institutions; infrastructure; macro-economic stability; personal security; human capital; goods, labor, financial market efficiency; technological readiness; openness/market size; business sophistication; innovation	Survey of local and expatriate business executives	2003
Index of Economic Freedom (Heritage Foundation Wall Street Journal)—161 countries	Government involvement, trade and monetary policy, banking and finance, capital restrictions, wages and prices, property rights, regulation, informal economy	Assessment of mostly regulatory information	2004
FDI Confidence Index (A.T. Kearney)—64 countries among the world's foremost FDI recipients	Company investment intentions	Survey of foreign investors	2003

SOURCE: Nathan Associates, based on OECD, Investment Committee, *Mobilising Investment for Development: Role of ODA*, Annex 2, Table 1 (adjusted to reflect recent revision of WEF index and Doing Business Survey).

improve fundamental market characteristics. Such improvements might include market enlargement through regional trade arrangements to attract FDI, and harmonizing and liberalizing trade and investment rules and standards with trading partners through those agreements (see Chapter 6). In doing so, governments may forgo some policy flexibility as a worthwhile tradeoff to make markets more attractive and the investment climate more certain for potential investors.

Table 5-2

Selected Reform Measures and Countries Where They Have Been Implemented, by Business Area

Starting a Business			
Registration as an administrative (non-regulatory) process	Use of single identification number	No minimum capital requirement	Electronic application made possible
Canada, Chile, Italy, Serbia and Montenegro	Belgium, Estonia, Morocco, Turkey	Botswana, Ireland, Tanzania, Thailand	Latvia, Moldova, Sweden, Vietnam
Hiring and Firing Workers			
Long duration of fixed-term contracts	Apprentice wages for young workers	Redundancy as grounds for dismissal	Moderate severance pay for redundancy
Austria, Costa Rica, Denmark, Malaysia	Chile, Ecuador, Finland, Tunisia	Armenia, Botswana, Lebanon, Russia	Finland, Madagascar, Namibia, Uruguay
Registering Property			
Consolidate procedures at the registry	Unify or link the cadastre and property	Make the registry electronic	Complete the cadastre
Lithuania, Norway, Thailand	Australia, Netherlands, Slovakia	Italy, New Zealand, Singapore	Austria, Czech Republic, Denmark, Ireland
Enforcing Contracts			
Summary proceedings for debt collection	Case management in courts	Limiting of appeals	Responsibilities for enforcement moved out of courts
Bosnia and Herzegovina, Finland, Lithuania, Philippines	India, Malaysia, Slovakia, United States	Botswana, Chile, Estonia, Greece	Hungary, Ireland, Netherlands, Sweden
Getting Credit			
Legal protections in collateral law	No restrictions on assets for collateral	Sharing of positive credit information	Data protection laws to ensure quality
Albania, New Zealand, Slovakia, United States	Australia, Singapore, UK	Germany, Hong Kong, Malaysia	Argentina, Belgium, United States
Protecting Investors			
Derivative suits permitted (i.e., shareholder suits against management on behalf of firm)	Institutional investors are active	Disclosure of family and indirect ownership	Public access to financial and ownership data
Chile, Czech Republic, Korea, Norway	Chile, Korea, UK, United States	Denmark, Sweden, Thailand, Tunisia	Germany, Poland, South Africa
Closing a Business			
Improved efficiency in foreclosure process	Specialized expertise in the courts	Limiting of appeals	Administrators paid for maximizing value
Armenia, Kenya, Nepal, Paraguay	Colombia, India, Latvia, Tanzania	Australia, Estonia, Mexico, Romania	Denmark, Japan, Jordan, Malaysia

SOURCE: World Bank, *Doing Business in 2005,* (Table 1.3).

Governments, however, must do more than make formal changes in laws and policies. As they put reformed laws and policies into practice, they face four challenges: restraining rent-seeking, establishing credibility, fostering public trust and legitimacy, and ensuring that policy responses fit local conditions.

Exhibit 5-1
Illustrative Regulatory and Incentive Measures in Foreign Investment Regimes

Regulatory/Channeling Measures

Screening, Admission, and Establishment

- Closure of certain sectors, industries, or activities to FDI
- Minimum capital requirements
- Restrictions on modes of entry, forms of ownership, foreign share of equity

Performance Requirements

- Local content
- Minimum export shares
- Trade or foreign exchange balancing
- Technology transfer
- Local equity participation
- Employment targets
- R&D requirements

Incentives

Fiscal

- Reduction in standard corporate tax rate
- Tax holidays
- Reduction in social security contributions
- Accelerated depreciation allowances
- Entry exemptions and drawbacks
- Export tax exemptions
- Reduced taxes for expatriates

Financial

- Investment grants
- Subsidized credits
- Credit guarantees

Other

- Subsidized service fees for power, water, telecommunications, transportation, etc.
- Subsidized designated infrastructure (e.g., commercial buildings)
- Preferential access to government contracts
- Closure of the market to further entry/granting of monopoly rights

SOURCE: Nathan Associates, based on Asian Development Bank, *Asian Development Outlook 2004, Foreign Direct Investment in Developing Asia*, Table 3.3.

INTERMEDIATE MEASURES—SPECIAL FDI REGIMES

Full-scale improvement of the investment climate is the best way to attract FDI, but the complexity, slow pace, and political risks of wholesale reform may make such an approach difficult for some governments. Thus, governments often seek to attract FDI by granting the foreign affiliates of multinationals privileged status within the economy.

Special FDI regimes may involve incentives or mechanisms that channel and control FDI to maximize certain development effects. The latter include regulatory controls such as performance requirements, or restrictions on modes of entry (e.g., greenfield, but not mergers and acquisitions), or closure of sectors to FDI (Exhibit 5-1). None of these regimes has proven fail-safe, and many are a gamble even under the best of circumstances.[16] Nevertheless, they are popular among governments, which continually modify them to attract FDI (Table 5-3). Three kinds of special measures are especially popular: administrative streamlining and one-stop shops, export processing zones, and incentives.

ADMINISTRATIVE STREAMLINING AND ONE-STOP SHOPS

Countries often require investors to navigate a complicated sequence of approvals and permits

FDI and EPZs Spur Economic Development in Mauritius

Its development prospects famously declared grim by economist and Nobel Prize winner James Meade in the early 1960s, Mauritius has confounded expectations to become a rare success in sub-Saharan Africa. Mauritius' transformation from a monocrop sugar economy to a diversified one—services now make up 70 percent of GDP—reflects a development path catalyzed by FDI.

In 1970, the country was the first in Africa to adopt an Export Processing Zone (EPZ) act. Using its access to markets under the Lome Convention, peaceful multicultural social relations, very high multilingual literacy rate, and incentives such as tax holidays, Mauritius convinced Chinese and other Asian investors to locate textile and garment production in its EPZs. The country's EPZ strategy took root and flourished in the 1970s and again in the 1980s, a boom time for multinationals moving into the zones to take advantage of generous incentives offered by the government (e.g., reduced corporate tax rates). Instrumental in consolidating support for the EPZ and shaping related policy was the Mauritius Export Development and Investment Authority (MEDIA), now known as the Mauritius Industrial Development Authority (MIDA).

FDI in the EPZ proved critical to industrial diversification, employment, export development, and economic growth. Indeed, Mauritius demonstrates how inward FDI can stimulate domestic investment and outward FDI—the country's main exporters are now national companies.

In the 1990s, manufacturing FDI declined as labor productivity stagnated, labor costs rose, preferential trade access ended, and cheaper regional alternatives emerged. The changing dynamics of the garment/textile sector prompted South–South investment outflows (e.g., to Madagascar) and an expansion of investment in the services sector. In the late 1990s, offshore services began to provide high value-added jobs for bankers, lawyers, accountants, and others.

As of December 2001, some 14,000 offshore entities were registered with the Mauritian government, many targeting commerce in India and South Africa. The government is now using investment incentives to promote the services sector. Its "Cyber City Project," for example, is designed to attract call centers (especially serving Francophone Africa, France, and Canada); companies investing in call centers and back office services can opt for a uniform corporate tax rate of 5 percent.

to establish foreign affiliates, develop land and sites, connect to utilities, and obtain and renew operating certificates (e.g., import-export permits, health and safety inspection, labor inspections). Associated costs and delays tend to be especially excessive for FDI-related land and site development permits and for import-export operating requirements.

To reduce the red tape that gives rise to these costs, reforms have concentrated on administrative, technological, and institutional solutions: simplifying paperwork, e-registrations and virtual interagency networks, and establishing one-stop shops for all procedures. In general, these solutions have been useful, although not necessarily automatic or complete. For example,

Table 5-3
Changes in National Regulations on FDI, 1991–2003

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Number of countries making changes in investment regimes	35	43	57	49	64	65	76	60	63	69	71	70	82
Number of changes	82	79	102	110	112	114	151	145	140	150	208	248	244
More favorable to FDI[a]	80	79	101	108	106	98	135	136	131	147	194	236	220
Less favorable to FDI[b]	2	0	1	2	6	16	16	9	9	3	14	12	24

[a] Including liberalizing changes or changes aimed at strengthening market functioning, as well as increased incentives.

[b] Including changes aimed at increasing control as well as reducing incentives.

SOURCE: UNCTAD, *World Investment Report 2004*, Table I.2.

the success of one-stop shops, a prominent investment-related reform measure, has been a function of clearly defining mandates and lines of authority to expedite approvals. Otherwise the process again becomes bureaucratic and inefficient.[17] In sum, while comprehensive reduction in administrative barriers may ultimately require full-scale reform and liberalization of the public sector, in the interim, some strategic, carefully planned approaches can streamline the administrative framework for investment, to the benefit of foreign and domestic investors.[18]

EXPORT PROCESSING ZONES

Nearly every successful export-led growth strategy in Southeast Asia and throughout the developing world in the last 40 years has started with an enclave approach—free trade zones, export processing zones, bonded warehouses, or special economic zones, as in the case of China. In solving most regulatory and other business control problems in a small area, enclaves have represented a politically savvy approach yielding good results while approaching the enormous challenge of economy-wide reform gradually.

Among enclave options, export processing zones (EPZ) have been particularly popular.[19] More than 3,000 EPZs in 116 countries employ 43 million workers, mostly women.[20] Concentrated in textiles, apparel and consumer electronics, EPZs have been used to stimulate exports of nontraditional goods, generate employment, and attract foreign investment. EPZs attract foreign direct investors through tax concessions, superior infrastructure, reduced administrative barriers, and duty-free import of components used in export production.

EPZs have long concentrated on manufacturing goods for export but are now incorporating services in response to the upward trend in efficiency-seeking FDI in that sector. In such a zone, workers may provide data processing or call center services. ICT infrastructure is critical for such zones, as are productive, cost-effective workers and managers. Traditional EPZs may well be useful in attracting FDI for many countries, but the more labor-intensive zones may decline in importance given the industry shifts described in Chapter 4. In addition, the export subsidies that are the heart of EPZ operations have been questioned since 1995 as possibly violating WTO agreements, depending on the host country's income level. This is likely to discourage some future EPZ activities (Exhibit 5-2).[21]

In sum, EPZs have helped generate employment and launch industrialization in difficult economic environments. But their enclave nature may tend to isolate benefits. EPZs need to be linked to the general economy's industrial and commercial centers and to a well-educated workforce to facilitate the spillovers and technology transfers that motivate the pursuit of FDI.[22]

Exhibit 5-2

Can EPZs Violate WTO Rules?

How an EPZ assists exports may constitute a violation of the WTO Agreement on Subsidies and Countervailing Measures (SCM), which took effect in 1995. A subsidy is

- *Prohibited* if it is contingent on export performance or requires the use of domestic instead of imported inputs;
- *Actionable* if it harms another WTO member; and
- *Non-actionable* if it is general, not granted to a specific sector or producer, or if intended to enable scientific research, benefit disadvantaged regions, or encourage adoption of environmental regulations.

Prohibited subsidies include the direct transfer of funds by the government to exporters, provision of goods and services other than infrastructure by the government, and the reduction or elimination of tax revenues that would normally be due the government. Tax breaks for exporting firms, including duty exemptions on imported machinery used to produce goods for exports—measures common in EPZs—thus may be considered prohibited, if granted to a specific sector.

When the effect of the subsidies on other WTO members is minimal, developing countries are treated more liberally than developed countries. For example, even though export subsidies were prohibited as of January 1, 2003, developing countries could request a one-year extension of the exemption period and consult with the Committee on Subsidies and Countervailing Measures to determine whether an extension is justified. By mid-2003, more than 24 developing countries had submitted requests for extensions, including Colombia, Guatemala, Panama, and Thailand. Extensions may last through the end of 2007. In addition, least-developed countries may retain export performance subsidies as long as they remain under the income threshold (as defined by UNCTAD, plus WTO members with per capita incomes of under $1,000 per annum).

Countries that may be exempt from the SCM Agreement or portions of it are as follows

- **Least-developed and developing countries** Angola, Bangladesh, Benin, Burkina Faso, Burundi, Central African Republic, Chad, Democratic Republic of the Congo, Djibouti, Gambia, Guinea, Guinea-Bissau, Haiti, Lesotho, Madagascar, Malawi, Maldives, Mali, Mauritania, Mozambique, Myanmar, Niger, Rwanda, Senegal, Sierra Leone, Solomon Islands, Tanzania, Togo, Uganda, Zambia
- **Least-developed countries joining the WTO** Bhutan, Cambodia, Cape Verde, Laos, Nepal, Samoa, Sudan, Vanuatu, Yemen
- **Developing countries with a GNP per capita of less than $1,000 (SCM Agreement, Annex VII, paragraph b)** Bolivia, Cameroon, Congo, Cote d'Ivoire, Dominican Republic, Egypt, Ghana, Guatemala, Guyana, India, Indonesia, Kenya, Morocco, Nicaragua, Nigeria, Pakistan, Philippines, Senegal, Sri Lanka, Zimbabwe

Of the 27 countries negotiating WTO accession, Azerbaijan, Tajikistan, Ukraine, Uzbekistan, and Vietnam may also be exempt because their per capita GNP is below $1,000 per annum. Figures were calculated according to the World Bank's World Development Indicators online database. Each country's GDP (constant 1995 US$) from 1997–2001 was divided by the total population for the same period. The average GDP per capita for the period was used to estimate the GNP. This list does not include Serbia and Montenegro, whose data were unavailable.

SOURCE: David Robertson. 2001. Export Processing Zones and the WTO Agreement on Subsidies and Countervailing Measures. In *International Tax Competition: Globalization and Fiscal Sovereignty*. Edited by Rajiv Biswas. 2002. Commonwealth Secretariat: London.

INCENTIVES

Most developing and developed countries alike provide incentives for FDI. The most common incentives are fiscal—tax holidays, special tax reductions, and the like;[23] others include construction of special infrastructure for particular types of projects, and various grants and subsidies. These incentives are justified on the basis of the direct and indirect benefits of FDI and the hope of creating industrial agglomerations or clusters of foreign firms that can accelerate development and attract more investment. But the tradeoff can be costly. OECD analysis shows that incentives offered automobile manufacturers in Central Europe amounted to more than $200,000 for each job eventually created.[24] When incentives include cash subsidies and outlays for infrastructure, or other financial incentives, the price can rise rapidly. And, whatever their benefit, such incentives create economic distortions and inefficiencies that work against local firms that do not qualify for them.

Given these costs, are incentives an effective way to attract FDI? At least according to conventional wisdom, tax incentives—in Ireland, Malaysia, Costa Rica, and Mauritius—seem to have stimulated FDI. But there is ample evidence that many multinationals rate a stable and predictable tax regime as a more critical determinant than tax incentives.[25] All things being equal, tax incentives may marginally affect location decisions for efficiency-seeking, export-oriented FDI projects.[26] Their influence on market-seeking FDI may be even less significant.

When governments deem incentives necessary, they should, at a minimum, define the package carefully—leaning perhaps to time-bound and moderate tax incentives rather than outright subsidies or other cash outlays—and subject it to a rigorous cost–benefit analysis. And regardless of the particular package, specialists stress that "non-tax elements of the investment climate are far more important than tax incentives in determining the level and quality of investment."[27]

DIRECT ACTION—PROMOTING FDI

An attractive investment climate is nearly always a prerequisite for attracting FDI, but for most countries it is not enough. They must promote investment directly. Relatively new in developing countries, investment promotion took root in the rising quest for FDI after the debt crisis of the 1980s and acceptance of the notion of "marketing a country."[28] The number of investment promotion agencies (IPAs) surged in the 1990s with the emergence of the transitional economies of Eastern Europe and the creation of new nations from the former Soviet Union. The membership of the World Association of Investment Promotion Agencies (WAIPA) now includes 167 agencies, about 80 percent from developing countries.

Table 5-4
Investment Promotion Agencies—Income Sources and Expenditure Use of Funds

Income Sources	%	Expenditure Use	%
Government funding	73	Image building	38
Revenues earned from fees	10	Investment generation	29
International aid	9	Investor services	25
Other sources	6	Policy advocacy	8
Private sector	2		
Total	100	Total	100

Note: Income sources from UNCTAD, *The World of Investment Promotion at a Glance—A Survey of Investment Promotion Practices,* ASIT Advisory Studies No. 17, Figure 4, p. 4.

SOURCE: Nathan Associates.

CzechInvest—Model IPA in the Transition Economies

The Czech Republic leads Central and Eastern Europe in attracting FDI. Indeed, the country recorded an estimated US$ 5 billion in FDI in 2004—$488 per capita, compared to $169 in Hungary and $131 in Poland, two rival economies with similar cost advantages and education levels. The difference? CzechInvest, the country's investment promotion agency.

Established in 1992 by the Ministry of Industry and Trade (MIT), with assistance from Ireland's IDA experts, CzechInvest at first focused on marketing the Czech Republic to ensure FDI inflow for industrial restructuring and development. But since its merger in 2003 with two complementary agencies—CzechIndustry, which handles sector programs, and Business Development Agency, which supports small and medium sized businesses—Czechinvest has taken on broader responsibilities. These include management of MIT's programs for business development and acting as intermediary between the European Union (EU) and the Czech Republic's small and medium enterprise sector in the use of EU structural funds for business. Still receiving its budget from the MIT, CzechInvest provides foreign investors with free services, such as business consulting, handling of investment incentives, business properties identification, supplier identification, investor after-care, business infrastructure development, and access to structural funds.

The agency is currently targeting research and development, business support services, and high-end manufacturing (especially automotive, electronics, life sciences, high-tech engineering, and plastics). CzechInvest has set the standard for investment promotion in the transition economies of Central and Eastern Europe.

PROFILE OF INVESTMENT PROMOTION AGENCIES

In most developing countries, IPAs are government entities that report to a ministry, though often without being a part of it and operating under a separate board of directors.[29] IPA boards are composed of public and private sector representatives, including representatives of training and educational institutions and business associations. IPA staff, who are not necessarily civil servants, may be paid higher salaries than their counterparts in the civil service and have had careers in government, though some have private sector experience.

Government typically supplies the vast bulk of IPA funding, but many agencies are trying to supplement this with revenues from other sources, such as for-service fees and donor agency funds (Table 5-4). When clients do pay fees, they are usually for business services, legal assistance, help in preparing feasibility studies, and support in identifying qualified local personnel. Most IPAs continue to resist fees for services as contrary to their marketing role. According to data from 2000, annual budgets for the IPAs of least developed countries average $285,000; of economies in transition, $700,000; and of other developing countries, $1.5 million. The budgets of banner IPAs run higher: Economic Development Board (Singapore), $45 million; Industrial Development Agency (Ireland), $40 million; CINDE (Costa Rica), $11 million; and MEDIA (now MIDA of Mauritius), $3 million.[30]

IPAs tend to concentrate on the following types of activities:[31]

- ***Image-building.*** IPAs strive to convey a positive image of their country to international

investors and the business community worldwide. In doing so, they use public relations and advertising techniques and increasingly turn to the Internet, especially their own websites, as primary tools.

- ***Investment generation.*** An IPA's most fundamental activity is creating a flow of FDI prospects. This can take many forms, from cold-calling to highly selective targeting, and involves trade and investment fairs, investment missions and seminars, direct mail campaigns, and personal visits to potential sponsors of FDI projects. Encouraging existing projects to reinvest and expand the scale or scope of their operations has also proven to be an excellent strategy for generating investment.
- ***Investment facilitation and servicing.*** IPAs support foreign investors in the pre-establishment and operational phases of an investment. Their goal is to reduce the time between "first contact" and actual production. They assist investors in evaluating an opportunity; provide information and support regarding registrations, approvals, and permits; and help investors obtain essential services such as utilities and leasing arrangements. Many services in the pre-establishment and establishment phases involve one-stop shops. Services in the operational phases involve monitoring to ensure that FDI projects encounter minimal red tape in renewing licenses and permits, and generally have a positive experience with host-country policies and conditions. Such "after-care" servicing is now especially important in retaining or expanding FDI projects, and as a promotion approach, is particularly cost-effective: in some countries more than 50 percent of FDI is generated from existing investors.[32]
- ***Policy advocacy/business environment improvement.*** Policy advocacy is fast becoming a very important function for IPAs. IPAs frequently join business environment task forces and survey investment climates, then communicate the concerns of investors, foreign and local, to government. IPAs are increasingly viewed as informed and effective advocates for getting the investment climate right, and for spurring public–private dialogue on policy matters.

These functions are not exhaustive. In fact, some IPAs grant incentives, promote privatization, or even supervise EPZs. Reflecting the shift in approaches to FDI, IPAs have evolved over the past 15 years. Their regulatory function was once prominent and policy advocacy absent. Now, the reverse is true. IPAs are increasingly focused on customers and investors, not regulation.

IPA EFFECTIVENESS

Are IPAs effective? Responses vary according to host country and specific agency, but for IPAs as a group, the answer may be yes. Recent cross-country research of 58 agencies yielded interesting insights.[33] First, IPAs appear to be positively correlated with FDI inflows, along with market size and GDP per capita. If causality is assumed to run from IPA promotion to FDI inflows, a 10 percent increase in expenditure on promotion seems to yield a 2.5 percent increase in investment. Second, investment promotion seems to be more effective in countries with a good investment climate and a relatively advanced level of development. In countries with a poor investment climate, promotion may even be counterproductive. Third, among IPA functions the most fruitful seems to be policy advocacy, followed by image building and investment facilitation and servicing. Investment generation may be the least cost-effective, at least for the countries surveyed. Finally, the success of an IPA depends very much on (1) a strong, visible relationship to the highest offices of government (president or prime minister), and (2) the participation of the private sector in IPA activities through the board of directors. IPAs may also draw upon a "toolbox" of approaches and procedures, many defined by the Multilateral Investment Guarantee Agency (MIGA).

BEST-PRACTICE ISSUES

Given such encouraging research results and continuing stiff competition for FDI, IPA programs will continue to expand throughout the developing world. As they do, they face four issues, one organizational and three functional.

Integrating trade promotion and investment promotion. Many governments are moving to unite previously segregated trade and investment promotion functions in one agency. The reasons for doing so are strategic and practical. First, trade and investment are closely related; the export capabilities of a developing country often depend heavily on improving productivity through investment. And when upstream supply linkages are created between FDI-based foreign affiliates and domestic firms, the latter often progress to become independent exporters. Hence, promoting trade and investment in tandem promises to make the most of inherent synergies. Further, for small countries, size, institutional limitations, human resources, and sectoral structures all may make a hybrid promotion agency a practical option. Reasons for not uniting promotion activities include possible dilution of focus and institutional complexities. Here, the "correct" response is probably very specific to each country, but should be based on careful analysis on both the trade and investment sides.

Making policy advocacy a priority. Because the investment climate is fundamental to attracting FDI, IPAs are increasingly advocates for a good climate. They are in a unique position to define and communicate concerns to policymakers, recommend specific improvements, organize cross-sector alliances of investors for reform, and explain how FDI benefits host-country populations. Policy advocacy is likely to grow in importance and require larger budget allocations (Table 5-4). A useful approach to advocacy could be modeled on the annual report of Invest in Sweden (ISA)—"The Climate for Foreign Investment in Sweden." This report reviews the country's competitiveness in light of FDI trends, and provides a systematic framework that underscores policy reform needs from an FDI point of view.[34]

"Picking winners" and targeting investors. Often used derisively, "picking winners" pertains to national investment promotion policies that target specific subsectors for FDI (e.g., financial services software, medical instruments, agricultural-blood stock services). The research findings on investment generation cited earlier challenge the wisdom of such policies. Supporters, however, cite situations where targeting policies may have been part of successful integrated development strategies (e.g., Ireland, Singapore, Mauritius, Costa Rica, Czech Republic, and Malaysia). In many such cases, after these countries established a broadly favorable investment climate, their governments not only targeted sectors, but, in concert with IPAs, took action to create competitive advantages in those sectors. For example, they invested in infrastructure improvements such as high-speed broadband, created new school curricula, and introduced special utility tariffs—all to meet the needs of specific FDI targets. With the legendary successes of Ireland IDA or Mauritius MIDA before them, more countries may be tempted to adopt sophisticated and targeted approaches to investment promotion. The costs, benefits, and risks of such approaches should be weighed carefully and compared to those of a general improvement in the investment climate. Incentives have rarely made any substantive difference in the absence of an attractive business enabling environment.

Promoting local linkages. Governments are more and more concerned with building linkages between FDI projects and the local economy and are often expecting IPAs to lead this task. In the past, such linkages were forced through performance requirements imposed on investors. These requirements yielded unsatisfactory results and are now recognized to be frequently inconsistent with WTO obligations. Again, IPAs would do well to observe some models. The Local Industry Upgrading Program of Singapore's Economic Development Board built

on partnerships with foreign affiliates that raised the productivity of local suppliers. Likewise, Ireland's National Linkage Program enhanced domestic productivity through subcontracting arrangements between foreign affiliates and local suppliers. The success of both programs seems to have been the real commercial opportunities and market solutions on which they were based, and their ability to mitigate the risks that both foreign affiliate buyers and local suppliers initially saw in dealing with each other.[35]

The task of investment promotion is indeed challenging, given IPAs' day-to-day functions and all the issues just summarized. Pragmatic policymakers in the developing world will likely put the matter of IPAs in proper perspective: investment promotion is a complement to the comprehensive work of building a solid and efficient general investment climate—the fundamental attraction for FDI.

6. INTERNATIONAL AGREEMENTS AND INSTITUTIONS FOR FDI

Open markets, together with predictability and rule of law, are central factors contributing to a positive investment climate and the attraction of FDI. Unilateral economic policy liberalization at the host-country level may be the most fruitful approach to achieving these ends, but cooperative action on an international scale can also be reinforcing. Accordingly, efforts to put in place international agreements that advance liberalization measures of interest to foreign investors have been continuous. The impetus for these agreements has come largely from the developed world—the major source of FDI—but developing countries are increasingly willing to accept these agreements as the price of attracting foreign investment. At the same time, several international organizations have been created to promote FDI flows to developing countries in recognition of capacity constraints in many of them.

INTERNATIONAL INVESTMENT ACCORDS

In 2002, the United Nations hosted a conference to address challenges relating to the financing of development needs. It attracted 50 heads of state or government, more than 200 ministers, and leaders from the private sector and civil society, as well as senior representatives of all major multilateral financial, trade, economic, and monetary organizations. Broad agreement was reached on a number of issues, and a consensus statement was issued. The Monterrey Consensus first acknowledges the importance of developing countries mobilizing domestic financial resources for development. Noting that such resources will fall short of development needs, however, it also recognizes the critical need for private international capital flows, particularly foreign direct investment.

Although this document is significant for the consensus it represents, it is hortatory and nonbinding. No comprehensive agreement liberalizes and governs FDI in the way that the WTO's systematic rules govern trade in goods. Rather, an extensive network of investment agreements links countries and regulates actions affecting foreign investment. Operating at a bilateral or a regional level, these agreements are supplemented by aspects of WTO agreements that address selected investment issues.

BILATERAL INVESTMENT TREATIES

Consisting of specific and binding rules, bilateral investment treaties (BIT) address investment issues between pairs of countries.[1] After the first BIT was adopted in 1959 the number grew steadily to 385 by the end of 1985. Once developing countries began concluding treaties with each other the number of BITs sky-rocketed to 2,000.[2] At present, 176 countries and territories have concluded such treaties.[3]

Initially BITs were signed between developed and developing countries so the former could secure high standards of legal protection for their firms' overseas investments. The United States, for example, negotiates BITs to secure investor protection, to encourage adoption of market-oriented policies that treat private investment evenhandedly and transparently, and to promote a stable and predictable framework to lower perceived risk for investors (Exhibit 6-1).[4] Developing countries negotiate BITs to help provide a favorable climate for foreign investment.

These treaties contain very few specific commitments to development. Their development role lies primarily in their presumed ability to promote investment by providing a welcoming and stable environment for foreign investment. BITs afford developing countries considerable latitude in applying national law and policy, especially with respect to admission of foreign investment, the imposition of operational conditions, and the granting of incentives. BITs often contain exceptions to general principles (e.g., for balance-of-payments considerations) that address development concerns. In general, however, they do not provide measures for such matters as technology transfer, technical cooperation, or specific home-country commitments.

FREE TRADE AND REGIONAL INTEGRATION AGREEMENTS

Free trade agreements (FTA) and regional integration agreements (RIA) focus on trade liberalization but often have important effects on investment liberalization. First, their trade-liberalizing provisions create a broader market for goods and services than the one that exists in any single country participating in the agreements. With this broader market, investors have

Exhibit 6-1
Provisions of the U.S. Model BIT

- Require each party to treat investments of the other as favorably as it treats domestic and third-country investment, from pre-establishment, to operation and final disposition ("national treatment" and "most favored nation").
- Stipulate limited exceptions in treaty annexes.
- Establish clear limits on expropriation and entitle investors to fair compensation.
- Provide investors the right to transfer funds out of the country.
- Prohibit trade-distorting practices such as performance requirements, including the use of local content or a requirement to export a certain share of production.
- Provide an investor in a dispute with a foreign government the right to international arbitration, with no obligation to use the government's domestic courts.
- Allow firms to hire top managers regardless of nationality.
- Prohibit states from lowering environmental and labor protections to promote investment.
- Require approval of two-thirds of the U.S. Senate to become effective on the U.S. side.

Bilateral Trade and Investment Framework Agreements (TIFAs)

Like other countries, the United States uses TIFAs to structure bilateral consultations on trade and investment. These are often considered a first step toward a BIT or an FTA. With their broad coverage of services, investment, and intellectual property, FTAs often require trading partners to undertake challenging internal reforms. The TIFA program can help identify reforms and reform strategies. Through a TIFA, the United States and a trading partner express certain broad interests such as a desire to expand trade in goods and services, adopt measures to encourage trade and create conditions favorable for long-term development, or encourage private sector contacts and investment. The TIFA provides a consultative mechanism for regular dialogue.

The United States signed its first TIFA in November 1987 with Mexico, nearly four years before NAFTA negotiations. It also signed TIFAs with countries in South and Central America and the Caribbean well in advance of negotiations for a Free Trade Area of the Americas (FTAA). In recent years, the United States signed TIFAs with Algeria, Egypt, Ghana, Morocco, Nigeria, Oman, Saudi Arabia, South Africa, Sri Lanka, Tunisia, Yemen, the West African Economic and Monetary Union, and the Common Market for Eastern and Southern Africa. The ASEAN countries recently concluded similar agreements with Japan, Australia, and New Zealand; Canada and Korea both have bilateral agreements with developing countries that promote investment; and the EU has bilateral cooperation agreements that aim to increase trade and capital flows with developing countries.

an opportunity to earn greater returns. And several RIAs include investment promotion provisions, featuring, for example, the exchange of information with regard to investment opportunities such as privatizations.

Second, these agreements may also contain provisions for liberalizing investment. Indeed, such agreements often go beyond BITs to liberalize investment policies or at least to eliminate specific investment restrictions. This is important. As emphasized in Chapter 5, these restrictions introduce market distortions that discourage FDI and hamper or dilute its effects on development.[5] FTAs and RIAs are often an effective framework within which to improve such policies, with substantial benefit to the investment climate and an opening up of opportunities for foreign investment. Some developing countries welcome this reform while others consider it an imposition. But nearly 300 FTAs or RIAs containing rules on investment could be in force by the end of 2005.[6]

The North American Free Trade Agreement (1994) and recently concluded FTA negotiations between the United States and Chile, Singapore, Australia, and the Central American countries and the Dominican Republic contain provisions similar to BIT obligations and, often, specific investment rules for financial services, monopolies and state enterprises, and temporary entry of business persons.[7] The rules prohibiting a government from imposing performance requirements apply not only to investments of a party's investors but also to investments of a non-party's investors. FTAs and regional trade agreements generally extend to third-party investors the same rights as investors in the regional trade area, especially when a third-party investor has a

substantial presence in one regional trade agreement member. For example, when a Japanese affiliate in Canada makes an investment in the United States or Mexico, it enjoys the same protections under the NAFTA as a Canadian-owned firm making a similar investment. A number of recent RIAs (and proposed RIAs and FTAs) have investment rules modeled on NAFTA.[8] To the extent that BITs and RIA investment provisions increasingly reflect similar standards, the spread of such agreements results in wide acceptance if not full multilateralization of common investment rules throughout the community of nations.[9]

WORLD TRADE ORGANIZATION

Although WTO negotiators during the Uruguay Round addressed specific investment policies that could distort trade in goods and services, the WTO does not have comprehensive rules governing members' investment policies and practices. Certain agreements concluded in 1994 and implemented beginning in 1995 do address particular aspects of investment:

- *General Agreement on Trade in Services (GATS)* deals directly with an investor's right to establish a presence in a foreign country to provide services and requires the host government to treat one foreign investor no less favorably than any other. Country-specific lists commit signatories to treating foreign investors as favorably as domestic service-providers in designated sectors.
- *Agreement on Trade-related Investment Measures (TRIMS)* is designed to ensure that governments do not apply measures to investments that restrict or distort trade. The agreement contains an illustrative list of performance requirements deemed inconsistent with WTO trade rules (e.g., mandatory domestic content, mandated exports, trade balancing requirements, domestic equity participation, technology transfer).
- *Agreement on Trade-related Intellectual Property Rights (TRIPS)* sets standards for the protection of certain categories of intellectual property, domestic enforcement measures, and dispute settlement. Intellectual property, such as patents and trademarks, often represents a significant portion of a firm's assets and falls within the definition of investment of most modern investment agreements.
- *Agreement on Subsidies and Countervailing Measures* limits or bans a number of investment incentive schemes, such as

Should International Accords Include Investor Obligations?

The extent to which investment agreements should commit signatories to imposing obligations on investors and what kind of obligations should be imposed are matters of debate. Many of these arguments are an extension of disputes about the implications of FDI for development, especially with regard to environmental and labor issues. Thus, some argue that investors from developed countries should meet their home countries' environmental standards when investing in developing countries lacking such standards. Others argue that governments should prevent home-country investors from manufacturing overseas products banned in their home markets. Some labor groups say that governments should hold firms accountable to high standards for labor relations overseas regardless of local requirements. Some countries have argued that home governments should ensure that their firms not engage in anticompetitive or restrictive business practices overseas. Some countries advocate cooperation and sharing of information generally to regulate the actions of transnational corporations.

Exhibit 6-2

Issues for the WTO Working Group on Trade and Investment, 2003

The Doha Ministerial Declaration of November 2001 tasked the Working Group on Trade and Investment (WGTI) with examining issues expected to shape the agenda of potential WTO investment negotiations. These issues include the following:

- **Scope and definition of "investment" and "investor."** Members have debated whether to employ a narrow (enterprise- or transaction-based) definition of investment or a broader definition based on assets, as well as different categories of investment. Some, including the United States, insist on a broad definition (i.e., one that includes portfolio as well as FDI). Others believe the Doha mandate is limited to a discussion of long-term investment.
- **Transparency.** Many members see transparency as essential to a stable, predictable, and secure climate for FDI. Nonetheless, not all agree on the nature and depth of transparency provisions as well as how to administer rules and regulations. Developing countries have expressed concern about onerous transparency commitments that would be difficult for them to implement.
- **Development provisions.** A number of developed and developing countries have advocated provisions that would allow developing countries to regulate investments according to national interests.
- **Consultations and dispute resolution.** Concerns have arisen with respect to the connection between a prospective WTO investment agreement and the existing WTO dispute settlement system.
- **Technology transfer.** Members have considered how technology is transferred by multinational corporations and absorbed by host economies.
- **Non-discrimination and pre-establishment commitments.** Some developing countries want to be able to discriminate in favor of domestic firms and screen FDI.
- **General and balance-of-payment safeguards.** Members generally agree that the kind of general and security exceptions usually found in WTO agreements should apply in any future investment agreement. There is also general agreement that these conditions must be clear to ensure that arbitrary or unjustifiable discrimination is not permitted.

subsidies that are contingent on the export of goods. (See Chapter 5 for a discussion of how this relates to FDI in export processing zones.)

At the 1996 WTO ministerial conference in Singapore, a working group on trade and investment (WGTI) was set up to examine the relationship between trade and investment, but with no negotiating mandate. At the ministerial conference of 2001 members agreed to begin negotiations toward a multilateral framework on investment after the conference scheduled for September 2003 in Cancun. The WGTI began preparatory work for such negotiations (Exhibit 6-2). However, no consensus was reached at the Cancun Ministerial and, in August 2004, ministers announced that the "Doha Development Agenda" (DDA) would contain no negotiations on investment.[10]

The question of whether to negotiate a full package of rules on investment is contentious. Many advocates, particularly among developed countries, have argued that such an agreement will give rise to larger, more sustained flows of FDI to developing countries by reducing host-country investment restrictions and better protecting investors' rights. Governments, however, cannot guarantee private investment flows. And without such a guarantee many developing countries are reluctant to accept an agreement that would curb their flexibility in setting investment policy as they see fit.[11]

INVESTMENT ACCORDS—IN PRACTICE, IN PROSPECT

Bilateral agreements have proliferated but perhaps with limited practical effect. Multilateralism in investment agreements seems as unlikely as ever. But regional trade agreements and dispute settlement activity are spreading and will probably continue to do so.

RECORD TO DATE

Measured against the objective of increasing FDI flows, the practical impact of BITs, regional agreements, and WTO investment action is mixed.

The proliferation of BITs suggests that they satisfy the demands of the states concluding them. While firms in developed countries receive additional protections if they choose to invest in a BIT partner's territory, do BITs attract foreign investment?[12] Recent research suggests that they do not.[13] A review of 20 years of data and FDI flows from OECD members to 31 developing countries shows that BIT signatories were no more likely to receive additional investment than countries without such treaties. In addition, countries with weak domestic institutions, including protection of property, have not benefited significantly by signing a BIT, and countries already reforming and with strong domestic institutions gain little from doing so.

Though BITs alone seem to have a negligible effect on investment flows, enhanced investor protections, in combination with reductions in trade barriers, do appear to increase FDI.[14] Witness the remarkable rise in FDI flows into Mexico as NAFTA took effect. Some experts suggest that FTAs in general tend to increase FDI,[15] others that the liberalization of Mexico's investment law in 1993, before NAFTA, made it easier for firms to take advantage of North American productivity-adjusted wage differentials. Nonetheless, NAFTA's protections have provided investors additional comfort and offset the disadvantages of Mexico's investment climate.[16] In any event, the general experience of FTAs and RIAs suggests two other points: such accords encourage adoption of international standards and best practices; and, despite claims to the contrary, do not tend to divert FDI

Encouraging Local Supply Links: Carrot or Stick?

Many developing countries seek to maximize the linkages between FDI-funded foreign affiliates and local markets in order to create employment and impart the technology and managerial know-how of foreign affiliates to the domestic economy. Linkage building is most effective when local workers and managers are trained in the quality standards of foreign affiliates, when they work directly to meet those standards (e.g., for on-time delivery), and when transport and communications infrastructure allows local supply systems to function efficiently. In contrast, mandatory local content requirements imposed by some host-country governments on foreign affiliates raise production costs for foreign investors, reduce the competitiveness of exports, and worsen perceptions of the investment environment. In addition, such policies are inconsistent with the provisions of the WTO's Agreement on Trade-related Investment Measures.

from non-participating to participating developing countries.[17]

Various WTO disciplines on investment have liberalized trade, at least to the extent that countries have challenged illegal practices so that losing parties have had to introduce reforms. Trade-related investment measures affecting the automobile sector have been challenged and reformed in Canada, India, and Indonesia; and investment-related measures involving trade in services have been challenged and reformed in Mexico's telecommunications regime. Separately, numerous dispute settlement cases have treated intellectual property and the enforcement of intellectual property protections.

Most BITs and specialized investment agreements, including those contained in FTAs and regional integration agreements, contain dispute settlement provisions. As BITs have proliferated, so have dispute settlement cases. Individual investors have brought the vast majority of these cases against states using international arbitration procedures. UNCTAD estimates that at the end of 2004, the number of cases brought under bilateral and plurilateral agreements totaled 160.[18] UNCTAD believes that foreign investors will increasingly avail themselves of the dispute settlement procedures of international investment agreements to challenge host-country actions that they perceive as harming their investment. Increased FDI flows could naturally lead to more occasions for dispute, and the growing number of BITs provides the ability to seek arbitration. UNCTAD also suggests that, following well-publicized claims, foreign investors are increasingly prepared to litigate.

FUTURE OF INVESTMENT AGREEMENTS

Given this record, future investment agreement activity is likely to involve more regionalism, new attention to investment promotion, and reaction to the growing number of dispute settlement actions.

First, in the near to medium term, the drive for future liberalization and rule-making in investment is likely to be channeled through regional, not multilateral, agreements. Developed countries made no progress on a multilateral investment agreement in the late 1990s, and developing countries thwarted the negotiation of comprehensive investment-related disciplines in the WTO in 2004. With prospects for a multilateral framework thus dimmed, proponents of WTO negotiations such as Japan and the European Union are more likely to pursue protections in FTAs and RIAs. Although Japan concluded a relatively modest FTA with Singapore in 2002, it signed its first truly comprehensive FTA in 2004 with Mexico. This FTA has investment provisions modeled on NAFTA, including clauses on investor–state dispute settlement. The agreement could serve as a precedent as Japan moves to negotiate FTAs with Korea and several ASEAN members. EU members are already aggressive BIT participants, and the EU itself has negotiated association agreements that include BIT-like investment provisions and requirements for the exchange of information on and the promotion of FDI. The Cotonou Agreement between the European Union and former European colonies in Africa, the Caribbean, and the Pacific also envisages the negotiation of "side-BITs" among signatories. And the United States will no doubt insist on investment provisions in FTA and RIA negotiations, such as those underway with several Andean countries and the South African Customs Union.[19]

Second, given developing countries' demands in Geneva for a guarantee that FDI will increase as a *quid pro quo* for adopting investment disciplines, bilateral agendas might broaden to address investment promotion. The Japan–Mexico FTA contains cooperative provisions to promote FDI, as do EU association agreements, including through facilities of the European Investment Bank. The extent to which developed countries might make investment promotion or development schemes directly contingent on acceptable investment protections in host countries remains to be seen.

Finally, the rising number of dispute settlement cases suggests increased liability for signatories to investment accords. In response, states could narrow the standard of protection for investors to reduce their own risk of litigation. In fact, some U.S. businesses have criticized the new model BIT and recent bilateral agreements for carving out certain industrial sectors, for not covering existing investment, for narrowing the definition of expropriation, and for allowing capital controls under certain circumstances.[20] Separately, the new model BIT and recent agreements provide for more transparency in dispute settlement procedures and discourage frivolous claims.

INTERNATIONAL INSTITUTIONS AND FDI

In addition to national investment promotion agencies (IPAs) operating directly on behalf of host countries, several international and regional institutions are also seeking to facilitate FDI flows to foster economic development. These institutions were created to (1) supplement the financial and technical resources of developing countries so they can pursue foreign investors more effectively and fully realize the benefits of inward FDI; and (2) mitigate the elevated political and economic risks in many developing countries in a general effort to stimulate FDI flows.

BUILDING CAPACITY TO PROMOTE INVESTMENT

International public sector institutions involved in building capacity in FDI promotion are varied in form and structure (Table 6-1). Their evolution correlates with the growing recognition of the importance of FDI and investment promotion in the 1980s, a period of debt crisis when the borrowing choices of many developing countries were severely constrained and competition for FDI was more aggressive than it had ever been before. Comparisons of investment promotion and industrial marketing suggested that countries could market themselves to multinational foreign direct investors just as large-scale suppliers marketed goods and services to corporations. More recently, in the wake of global recession and declines in FDI flows in the early 2000s, the 2002 Monterrey Consensus, which acknowledged the importance of FDI and other private international resource flows for development, has given more impetus to public sector efforts to build developing countries' capacity for investment promotion.

To build such capacity, international institutions provide assistance in implementing liberalizing agreements on investment issues; training in investment promotion skills; institutional needs assessments and development of strategic plans; FDI promotion workshops and simulations; and IT applications for dissemination of investment opportunities and market intelligence. Institutions frequently cooperate in delivering these services. For example, the Multilateral Investment Guarantee Agency (MIGA) collaborates with USAID and the World Association of Investment Promotion Agencies (WAIPA), often delivering joint workshops and training seminars in sub-Saharan Africa, the Balkans, and Asia.

Particularly valuable are the support tools, market research, websites, information dissemination networks, and publications that MIGA has developed to help IPAs perform effectively. For example, MIGA's Investment Promotion Toolkit helps IPAs organize themselves, formulate promotion strategies, target investor prospects, build investor servicing programs, and make use of the Internet, software, and other information technology. IPA professionals use MIGA's online FDI Promotion Center to share knowledge, and corporate investors use MIGA's IPAnet to learn about opportunities for FDI in emerging markets. IPAs and investment promotion specialists worldwide use all these resources.[21]

MITIGATING RISK ASSOCIATED WITH INVESTMENT

Major global events such as the Asian Financial Crisis of the 1990s, economic troubles in Argentina and elsewhere in Latin America, and

the September 11 terrorist attacks have heightened perceptions of risk in emerging country markets. But even without such events, foreign direct investors express common concerns with the business environments of developing countries. These concerns focus on variables that affect profitability: convertibility, taxation, and profit repatriation; expropriation and political stability; and rent-seeking and transparency of business transactions, regulatory systems, and institutional

Table 6-1
International Institutions Building Investment Promotion Capacity

Institution	Mission	Activities	Tools, Products, and Instruments
Foreign Investment Advisory Service	Founded in 1985 as a joint service of the World Bank and IFC.	Provides advice and recommendations to governments (often fee-based).	• Diagnostic of policy impediments • Self-assessments for monitoring progress on reform
International Chamber of Commerce	Based in Paris and founded in 1919 as a forum for international businesses. Members are multinational companies and individuals in 130 countries.	Organizes conferences, positions papers, and commercial dispute resolution.	• Business policy statements to governments and international institutions • Collaborates with UNCTAD on investor surveys • International commercial arbitration
International Finance Corporation	Established in 1956 as an arm of the World Bank group. Largest public multilateral source of loan and equity financing for private sector projects in developing countries.	Provides equity and other forms of financing for investors and entrepreneurs in developing countries.	• Products: project finance and syndication (loans, equity capital) • Domestic markets policy technical assistance
Multilateral Investment Guarantee Agency	Member of the World Bank Group, established in 1988 to promote FDI in developing countries through risk insurance.	Provides capacity building assistance for investment promotion and disseminates information on FDI.	• Risk insurance • Investment Promotion Toolkit • Online FDI services • Investment promotion websites
Organization for Economic Cooperation and Development	Based in Paris and established in 1961 from an organization set up to administer the Marshall Aid Plan. Members include European countries, Japan, United States, Mexico, Canada, Australia, New Zealand, and South Korea.	Promotes liberalization, best practices, and corporate governance on FDI. Delivers conferences, publications, and studies.	• Non-binding codes of conduct for multinational corporations • "Checklists" on best practices in attracting and governing FDI • FDI Reviews • Regulatory Impact Assessment
United Nations Conference on Trade and Development	Founded in the U.N. in 1964 and based in Geneva. As an intergovernmental forum, maximizes the integration of developing countries into the world economy.	Technical assistance, research, policy analysis, seminars, and workshops for capacity building and technical assistance.	• World Investment Report • Investment Compass • Country Investment Policy Review • Best practice cases on technology transfer through FDI
World Association of Investment Promotion Agencies	Founded in 1995 as a non-governmental organization in Geneva. Is a world forum for exchange of best practices in investment promotion.	Promotes cooperation among 167 member IPAs, including information gathering and advice on strategies and policies.	• Training workshops customized by region • Publications • Networking

governance. These concerns can be partly resolved through negotiations, but several private and public organizations provide risk mitigation instruments and related services and information:

- ***Overseas Private Investment Corporation (OPIC)*** was set up by the U.S. Congress to protect U.S. investors from loss of profits or assets from unexpected post-investment currency inconvertibility, expropriation, or other changes in political circumstances or government policy abroad. Similar entities in Europe often have mandates tied to trade finance, so that investment guarantee programs are housed in export promotion agencies (e.g., the UK's Export Guarantee Department, France's Compagnie Française d'Assurance pour le Commerce Extérieur, and Export Development Canada).
- ***Multilateral Investment Guarantee Agency (MIGA)***, part of the World Bank Group, offers guarantee products with standard 15-year coverage for various types of investment risk, such as risk associated with shareholder loans and franchising and licensing agreements, and for four types of political risk: currency inconvertibility and transfer restrictions, expropriation, war and civil disturbance, and breach of contract.
- ***Private investment insurers,*** including Lloyds of London and others, provide international risk insurance, often in cooperative under writing agreements with MIGA.
- ***Euromoney, World Economic Forum, Transparency International*** and similar organizations formulate rankings of country risk, perceived corruption, and country competitiveness that may only marginally affect specific decisions to invest but do send powerful signals about a country's image.

Other organizations such as the International Finance Corporation (IFC), part of the World Bank Group, can exercise a risk management function in FDI-financed projects. IFC provides project finance for private sector projects in developing countries, and its status and reputation as an international public sector entity can help reduce risk exposure for private investors.[22] The Private Sector Department of the Inter-American Development Bank (IDB), founded in 1995, has the same effect, especially for private financing of infrastructure.

Established in 1966, the International Center for the Settlement of Investment Disputes (ICSID) also plays a role in risk management. As noted earlier, disputes between investors and host countries are on the rise, with investors initiating most filings. By 2003, ICSID had registered 129 cases—half in the last five years. Created by international convention and set up within the World Bank Group, ICSID provides a mechanism through which firms from any of 140 member states can pursue disputes with host-country governments without involving their own home-country governments, and vice versa. Recourse to ICSID is voluntary, but once its arbitration is accepted, neither party can withdraw, and ICSID's results are binding. During the 1990s many BITs inserted clauses calling for governments to give prior consent to ICSID in the event of disputes. This amounts to a useful discipline on governments and a tool to reduce host-country risk in FDI projects.[23]

ATTRACTING INVESTMENT

By building capacity and mitigating risk, these institutions have strengthened the ability of developing countries to attract FDI. At an operational and organizational level, this has been especially beneficial for smaller economies and for countries and regions in post-conflict situations or political transition. But it is as "thought leaders"—helping developing countries identify, understand, and replicate best practices—that international institutions and bilateral donors may contribute the most to investment promotion. Indeed, this function may account in no small way for the evolution in investment promotion approaches described in Chapter 5.

7. PUTTING FDI TO WORK: STRATEGIC USAID ASSISTANCE

For developing country governments and businesses, the development case for FDI is clear: attracting FDI means sharing in the benefits of globalization in the 21st century. The requirement for harnessing FDI for development is also clear: aggressive modernization and liberalization of host-country economies. In essence, efforts to maximize the impacts of FDI pull together the whole range of issues at the heart of development thinking today—good macroeconomic management, microeconomic reform, private sector enterprise, technology transfer, and human capital development. For this reason, and because the issues involved call for highly specialized technical expertise and a best-practice perspective, maximizing the benefits of FDI is a highly productive and strategic focus for USAID assistance to developing countries.

FDI FACTS AND TRENDS

USAID programs to help developing countries maximize FDI benefits need to be fact-based and forward-looking. The preceding chapters provide references that highlight and define 12 facts and trends that these strategies must address:

1. FDI provides real and compelling development benefits, but they are not automatic. These benefits begin with FDI's boost to capital accumulation and direct employment, but the real payoff lies in technology transfer and human capital development, both of which boost productivity.

2. From the perspective of the multinational foreign investor, FDI projects are commercial transactions, motivated by very specific business considerations. Developing country governments need to distinguish among these motivations and to assess whether and how different kinds of FDI would fit into their economies.

3. A small group of large countries, led by China, dominates the receipt of FDI inflows in the developing world, as measured in absolute terms. Three-quarters of all developing country inflows go to 20 or so countries; the rest is divided among nearly 120 countries. But when measured on a per capita basis, even a little FDI can go a long way in a small economy.

Foreign Direct Investment and the Costa Rica Brand

How did Costa Rica become the top destination for foreign direct investment in Central America? In the 1970s and 1980s, when much of the region was coming to grips with the limitations of the import-substitution development model, Costa Rica was diversifying its export base and attracting U.S. investment. Like many developing countries, it used free trade zones (FTZ), a system established in the 1980s and based around industrial parks. A favorable investment climate helped the zones to flourish. In 1984, Costa Rica gained preferential access to U.S. markets when it ratified the Caribbean Basin Trade Partnership Act. It also ratified several bilateral investment treaties and provided other investor incentives.

The Costa Rican Investment Board (CINDE), a private nonprofit organization founded in 1982, has done much to boost the amount and quality of efficiency-seeking FDI entering the country. CINDE has vigorously promoted inward FDI in key sectors—high technology (e.g., electronics, medical devices), services (e.g., shared services, call centers), and tourism. In "branding" Costa Rica it has drawn on the country's location, labor, and sociopolitical advantages.

This brand has proved compelling to foreign investors such as Intel and Procter & Gamble. Intel located a $300 million semiconductor assembly production center in Costa Rica, after considering Brazil, Chile, and Mexico; and Procter & Gamble established a shared services operation there. Asked "Why Costa Rica?" foreign investors cite the country's relatively cheap and trainable workers—a key aspect of the brand—as well as political and social stability, preferential access and time-zone proximity to the United States, and export-oriented infrastructure.

Throughout the 1990s, inward FDI grew impressively, peaking at $620 million in 1999, laying the foundation for Costa Rica's development success to date. In 2002, FDI was $642 million.

4. Some FDI already flows to every part of the world, but it is not evenly distributed. China's overwhelming appeal, India's potentially huge appeal, and the loss of the Multifibre Arrangement of global quotas that long diverted FDI to poorer developing countries that investors would otherwise have deemed unattractive may all exacerbate this unevenness. All countries, but especially those in sub-Saharan Africa and Middle East/North Africa, need to look carefully at what attracts FDI to their economies—and what repels it.

5. The sectoral destinations of FDI flows in the developing world have changed definitively. Though no longer ascendant, the manufacturing-related FDI that dominated the 1980s and early 1990s is still important. The rise of the "global factory" will continue to generate efficiency-seeking FDI opportunities to manufacture parts and components for international production networks, but services-related FDI now accounts for most inflows, and will continue to do so. Most services-related FDI is still market-seeking, particularly investment in public utilities or finance. But this too is changing: efficiency-seeking activities such as export-oriented business support services are the fastest growing segment, and this expansion will accelerate.

6. The general attributes that attract FDI to a host country are well-known and straightforward. They begin with a set of economic-commercial factors that characterize any investment project: market size, market growth, and rising levels of GDP per capita; skilled and unskilled labor at favorable, productivity-adjusted wage rates; perhaps certain natural resources in abundance. But the quality of the investment climate, as determined by a country's policies, institutions, and infrastructure, is fundamental to attracting the efficiency-seeking and market-seeking FDI that tends to have the greatest development impact.

7. Getting the investment climate right to attract FDI involves creating the same conditions that encourage the domestic private sector in a host country—macroeconomic stability with low inflation and competitive exchange rates; a positive microeconomic enabling environment characterized by good governance, openness to trade, and minimum economic distortions; and reliable infrastructure, including physical, technological, and social services, especially in basic education and health. It also involves creating a low "policy risk" environment: once a sound policy environment is created, investors need to be confident that there will be no abrupt or arbitrary changes.

8. The characteristics of an attractive investment climate are well understood, but often require an enormous reform effort to achieve. Many governments, impressed by the complexity of the reform task and the urgent need for FDI, have chosen less ambitious, but more immediately effective measures to help attract FDI.

9. Governments often adopt intermediate measures to improve an aspect of the investment climate. These privileged regimes involve administrative streamlining or fiscal and other incentives, or a combination of incentives and/or infrastructure services in export processing zones. Though second-best to wholesale reform, such measures will remain popular, especially for locations lacking outstanding natural advantages for attracting investment.

10. Drawing on the special regime approach, investment promotion agencies have had some success marketing their economies as hosts for investment directly to the international business community. Given the tough competition for FDI, this sort of "targeting" will continue to have broad appeal to developing world governments, whatever the real returns and risks. In addition, the role of IPAs as advocates for business and investment climate reform is likely to grow.

11. Developing countries also undertake agreements—bilateral and regional—to improve their investment climates. These agreements and treaties impart predictability to investment climates, stabilize investment relations between countries, liberalize investment climates, and subject investment flows to binding rules. Global arrangements have proven elusive, but bilateral and regional accords will continue to spread. Their dispute settlement procedures are likely to generate more and more investor–state cases.

12. Several international public sector institutions related to foreign investment are now helping mitigate the risks attendant on FDI, arbitrate investment disputes, and build developing countries' capacity to promote investment.

STRATEGIC ASSISTANCE PRIORITIES

These 12 facts and trends constitute the environment in which USAID and all donors must deliver assistance to maximize FDI benefits. They also imply points of leverage at which such assistance is likely to yield the greatest relative return. USAID works within the framework of U.S. legislative and policy guidelines with respect to foreign direct investment, so the

Exhibit 7-1

Guidelines for USAID Investment Assistance

USAID support related to foreign investment must comply with legislative and policy guidelines. The most important of these is ADS 225, which outlines principles for trade and investment activities as they affect U.S. jobs and workers' rights and provides detailed policy, program, and implementation guidelines for investment activities

Issued in April 2003, ADS 225 supersedes Policy Determination (PD) 20, which had been in place since 1994. The new directive, entitled "Program Principles for Trade and Investment Activities and the 'Impact on US Jobs' and 'Workers' Rights'"

- Expands the list of permitted activities, giving Bureaus and Missions greater latitude in designing trade and investment activities;
- Refocuses the list of prohibited activities to those that can clearly be linked to inducing a firm to relocate; and
- Ends the requirement for a Presidential waiver for approval to support export processing zones (EPZs).

According to the General Notice announcing it, ADS 225 "balances USAID's objectives of promoting economic development with the sense of Congress that bilateral assistance should not be used to induce U.S. firms to relocate abroad, resulting in the loss of U.S. jobs."

To do this, the ADS classifies trade and investment activities as permitted, prohibited, and "gray-area" activities. Gray-area activities are generally permitted if there is no likely negative impact on U.S. jobs (determined according to standards in the ADS), and if permitted activities are designed and implemented so as to not contain or evolve into prohibited activities. Summarized here are some of the examples ADS 225 provides for each of the categories. Refer to the ADS for the exact language.

Permitted

- Policy dialogue
- Legal, regulatory, and judicial reform projects
- Dissemination and analysis of general economic and business information
- Enhancing the competitiveness of local producers
- Strengthening business and free trade associations
- Basic capital projects, and credit and micro- and small enterprise development
- Agricultural projects addressing food security needs
- Trade capacity building and trade facilitation
- Technical assistance relating to privatization and core labor standards

Prohibited

- Financial incentives to relocate
- Investment promotion missions to the United States to induce U.S. firms to relocate
- Advertising intended to encourage U.S. firms to relocate
- Certain support for organizations providing incentives to U.S. firms to relocate

Gray-area

- Technical assistance in establishing linkages with U.S. businesses
- Establishing investment promotion offices and financing investment promotion activities in the host country
- Activities involving EPZs
- Feasibility studies and travel and technical assistance for firms contemplating or planning investments in the host country

The specific provisions of the ADS provide more examples, analytical procedures and assistance clauses for gray-area activities, and further policy and definitions. USAID staff should seek legal counsel for any FDI-related activity to ensure compliance with ADS 225.

following priorities recognize those guidelines (Exhibit 7-1).

GEOGRAPHIC PRIORITIES

USAID should provide assistance for FDI only to developing countries that have demonstrated political will to undertake economic reforms and to improve their investment climates. But how should assistance priorities be set among those countries? Limited resources make it tempting to concentrate on countries inherently attractive to foreign investors (e.g., Eastern Europe, India, parts of Southeast Asia) to ensure that assistance has the greatest and most rapid impact. But doing so could worsen the FDI "gap," leaving the FDI have-nots even further behind. These include sub-Saharan Africa and developing countries that benefited from recently terminated textile and apparel quotas that had once enticed foreign investment.

Ultimately, USAID assistance in FDI issues should probably feature a mix: some host countries that are inherently attractive for FDI and others that are relatively less so. This mix should emerge through careful country-by-country analysis.

SECTOR PRIORITIES

USAID's FDI-related programs should remain flexible, rather than relying on a predetermined ranking of assistance priorities by sector or industry. While programs must take account of fundamental changes occurring in FDI flows, they must also be ready to assist host countries in dealing with issues related to investment in services, manufacturing, and natural resources.

TECHNICAL PRIORITIES

The strategic importance and technical complexity of six major issues associated with maximizing the benefits of FDI merit full attention. The relative ranking of assistance on these issues will depend on the specific circumstances of the host country. Assistance should focus on

1. ***Improving the microeconomic investment climate to benefit both foreign affiliates and domestic firms.*** Assistance should focus, first, on microeconomic reform measures of the "Doing Business" kind (e.g., practical regulatory streamlining for establishment, operation, and closure of businesses). These measures would apply at national and subnational or municipal levels. Second, assistance should be provided for development of competition policy to buttress trade and investment liberalization, improve the functioning of domestic markets, and help local industry and service providers compete with foreign goods and services and FDI-based foreign affiliates.

2. ***Forging better and stronger supply links between FDI-based foreign affiliates and local industries and service providers.*** Assistance should begin by creating links and then maximizing the technology transfers they make possible, including horizontal and vertical spillovers. This assistance would also attend to matters of workforce development that enable technology transfer and productivity spillovers.

3. ***Promoting private provision of infrastructure so infrastructure services become more reliable and cost-effective.*** Despite the mixed experience of the 1990s, private sector solutions—mostly FDI-based—are still the most promising for rapid improvement in infrastructure systems. Assistance should concentrate, first, on developing durable public–private contracting arrangements to mitigate the risks of such investments, from the perspectives of both the government and the service provider; and second, on creating regulatory systems that promote and maintain competitive conditions essential to cost-effectiveness.

4. ***Rationalizing FDI incentive packages to maximize the benefit-cost calculus.*** While such incentives are admittedly second-best

solutions, developing country governments will continue to use them to promote FDI. Assistance should provide methods and models for identifying, measuring, and weighing the net benefits and tradeoffs of incentives. This will help curb wholesale use of incentives and the distortions they introduce into an economy. Where appropriate, export processing zones and other enclave concepts could also be rationalized.

5. ***Helping investment promotion agencies, within USAID parameters, become more effective in general and better able to manage best-practice issues in particular.*** Such assistance will involve helping IPAs formulate promotion strategies and visions that mesh with national development strategies, create systems and procedures to implement those strategies, and devise processes to monitor and evaluate results. Assistance could also help some IPAs clarify the merits of merging trade promotion and investment promotion in one agency, of using targeting as a strategy, and of advocating policy reform.

6. ***Building capacity to negotiate international investment accords.*** Rather than concentrating on any single accord or negotiation, assistance should help developing country governments identify technical objectives and issues, understand tradeoffs, and develop models and strategies for negotiating bilateral investment treaties and investment provisions in general.

FUNCTIONAL PRIORITIES

For each of the technical areas just described, USAID assistance should encompass certain functions, most of which reflect or extend activities USAID has already undertaken to good effect (e.g., the Investor Roadmap program). As with the technical areas, priorities for assistance should reflect the needs of the host country. The functions are as follows:

- ***Benchmarking*** to identify facts and figures that help governments and business communities take stock of where they stand in each technical area, and enable USAID to calibrate assistance to the points of maximum payoff. Benchmarking should also provide indicators for measuring progress in the future.

- ***Program design*** to establish and rank objectives, define the content and limits of activities, and schedule plans of actions for host-country governments to make progress in any or all six technical areas. Benchmarking results should inform program design.

- ***Institutional development*** to make the processes, systems, procedures, and methods of host-country organizations involved in FDI-related reform more efficient. Such assistance should aim to ensure successful implementation of programs designed above. Here, on-the-job and formal training should figure prominently.

- ***Consensus-building and public–private dialogue*** so government and private opinion leaders are informed about the needs and technical issues associated with maximizing FDI benefits, and of the benchmarking, program design, and institutional development work that underlie reform initiatives.

- ***Evaluation*** to focus host-country governments, USAID, and other donors on what is actually maximizing the benefits of FDI for development in all the preceding functions. Such evaluations should highlight failures as well as successes and concentrate on understanding cause and effect.

- ***Knowledge management*** to assemble, digest, and organize information on all dimensions of attracting and maximizing the benefits of FDI. This could result in best-practice models and toolkits for any or all priority assistance functions in each technical area. Best practices would be widely disseminated among host countries, development practitioners, and other donors.

SUMMING UP

Foreign direct investment is a potent economic force worldwide. For developing countries it is the largest and most stable source of external finance and, as such, a critical variable in the market-oriented, export-based strategies that many have embraced. With prospects for a renewal of global growth brightening, FDI inflows to the developing world are likely to begin rising again, resuming their long-term trend of the past 30 years. These new and larger inflows will present policymakers in developing countries new opportunities—as well as new and greater responsibilities—for making the most of FDI. The policy and implementation issues involved in making FDI work for development are complex and challenging. Resolving them will ultimately depend on the problem-solving expertise and the political will of developing country governments and business communities. But in this globalized world, USAID and others in the donor community stand to play a critical role in helping host countries make FDI work for development.

ENDNOTES

CHAPTER 1

[1] United Nations Conference on Trade and Development, *World Investment Report 2004*, p. 8. (Referred to hereafter as *WIR 2004*.)

[2] Alwyn Young, "The Tyranny of the Number: Confronting the Realities of the East Asian Growth Experience," *Quarterly Journal of Economics*, 110, no. 3 (August 1995) is representative of the capital accumulation position. William Easterly's *The Elusive Quest for Growth, Economists' Adventures and Misadventures in the Tropics* (Cambridge, MA: MIT Press 2001) sets forth the total factor productivity side of the growth debate. Barry Bosworth and Susan M. Collins in "The Empirics of Growth: An Update," [(Brookings Institution, Washington D.C. 2003) (processed)] points to a resolution of the discussion.

[3] Research suggests that the three private development finance flows are not correlated (e.g., there is no reason to believe that a country receiving high amounts of FDI is also receiving high amounts of loans). See Barry P. Bosworth and Susan M. Collins, 1999, "Capital Flows to Developing Economies: Implications for Savings and Investment," Brookings Papers on Economic Activity: 1, Brookings Institution, pp. 151-152.

[4] Reported in International Monetary Fund, *Foreign Direct Investment: Trends, Data Availability, Concepts and Recording Practices (October 2004)*, p. 3. Also established in Organization for Economic Co-operation and Development, *Benchmark Definition of Foreign Direct Investment, Third Edition, 1996.*

[5] For simplicity, the economy in which the parent enterprise is resident is considered the "home country," while the economy in which the foreign affiliate is resident is considered the "host country."

[6] World Bank, *Global Development Finance 2004*, pp. 86-90. (Referred to hereafter as *GDF 2004*.)

[7] In addition to volatility, host-country and home-country policies and regulatory frameworks affect the composition of FDI: host-country local ownership requirements that limit project participation by foreign equity or repatriation rules that constrain dividend flows both tend to encourage intracompany loans in parent-foreign affiliate financing flows. Home-country tax policies that provide for tax deferrals until dividends from foreign affiliates are actually repatriated would have the same effect.

CHAPTER 2

[1] This typology of FDI flows from an enterprise perspective and is based on 1997 deliberations of the WTO's Working Group on Trade and Investment. See WTO, Document WT/WGTI/W/8/Add.1, "Implications of the Relationship between Trade and Investment for Development and Economic Growth."

[2] Unilateral and reciprocal preferential trade arrangements enlarge the effective size of developing country markets. The United States grants unilateral or "one-way" trade preferences in such programs as the Generalized System of Preferences, the African Growth and Opportunity Act (AGOA), the Caribbean Basin Economic Recovery Act (CBERA), and the Andean Trade Preference and Drug Eradication Act (ATPDEA). The European Union grants preferences through its Everything But Arms (EBA) program. Japan, Canada, and a number of other developed countries offer similar arrangements. Under unilateral preferences, special quota or tariff access is provided products originating in developing countries. Unilateral preference programs can be revoked at any time by the granting country and must be renewed periodically,

and they often restrict certain products of interest to developing country exporters. Two or more trade partners may negotiate a trade arrangement in which they grant reciprocal trade preferences that are not necessarily permanent. By contrast, trade agreements between countries are binding, cannot be revoked unilaterally without penalty, and do not require periodic renewal.

[3] Experts in the World Bank's Foreign Investment Advisory Services recently noted that "FDI is increasingly market seeking … offering opportunities to any country willing to open its markets or integrate with its neighbors." See Vincent Palmade and Andrea Anayiotas, "FDI Trends," *Public Policy for the Private Sector*, September 2004 at 3. Indeed, since the 1980s, market-seeking FDI stimulated by regional trade arrangements appears to have increased substantially, particularly where lesser developed and more developed countries are part of the same regional trade group.

[4] This is known as the "ladder effect." For example, in the late 1980s and early 1990s, labor-intensive manufacturing in electronics or industrial equipment migrated rapidly from the United States and Europe to China. As costs began to rise in China in the mid-1990s, these operations shifted to other lower wage locations in Asia. At the same time, a wave of more complex, value-added components manufacturing continued to move out of U.S. and European factories to these now more experienced but still vastly lower-cost Chinese manufacturing facilities, replacing the manufacturing sent on to South or Southeast Asia.

[5] Of course, global production networks in manufacturing and in services can be set up by equity (FDI) and non-equity means (outsourcing through subcontracting). Where FDI leads to the creation of foreign affiliates for a parent multinational enterprise, vertical integration of production is maintained. In general, it appears that where absolute lowest-cost labor motivates a multinational's efficiency-seeking (e.g., in textiles or footwear), subcontracting may be the mechanism of choice; where some technology and skilled labor inputs figure more in the production process, an FDI-based approach may be chosen.

[6] Lenovo Group chairman Liu Chuanzhi quoted in the *New York Times*, December 25, 2004.

[7] Ample empirical research emphasizes FDI's importance to capital accumulation through favorable effects on domestic investment. For example, unlike other external resource inflows (i.e., portfolio equity or debt) to developing countries that often fuel higher consumption or growth of foreign exchange reserves, an increase in FDI appears to end up as a one-to-one increase in real sector investment. See Bosworth and Collins, "Capital Flows to Developing Economies: Implications for Savings and Investment." Evidence also exists that, contrary to fears that FDI-financed foreign affiliates borrow heavily from host-country banks thus, "crowding out" local firms and exacerbating financing constraints, FDI eases these constraints. This holds true for high- and low-income countries, and for purely domestic firms. See Ann E. Harrison, Inessa Love, and Margaret S. McMillan, "Global Capital Flows and Financing Constraints," *Journal of Development Economics*, 75 (2004). And most dramatically, by stimulating complementary economic activities, FDI may "crowd in" domestic investment by an estimated factor of 1.5 to 2.3. See E. Borensztein, J. De Gregorio, and J-W Lee, "How Does Foreign Direct Investment Affect Economic Growth?" *Journal of International Economics* 45 (1998). On the other hand, UNCTAD in its *Trade and Development Report 2003: Capital Accumulation, Growth and Structural Change* cites studies that cast doubt on the relationship between FDI and capital accumulation, citing evidence of crowding out, especially in Latin America. But UNCTAD still concludes that "for the developing world as a whole, there is a positive but weak relationship between the share of FDI in GDP and the share of [Gross Fixed Capital Formation]." See pp. 76-78.

[8] Several empirical studies show positive relationships between FDI and overall economic growth. For example, a cross-country analysis of 31 developing economies over 20 years suggests that a 1 percent increase in the ratio of FDI to gross fixed capital formation would increase GDP by 2.25 percent, and that this result is robust across regions. See Henrik Hansen and John Rand, "On the Causal Links between FDI and Growth in Developing Countries," Development Economics Research Group, Institute of Economics, University of Copenhagen, mimeo (February 2004). Another finds that FDI raised GDP growth by 0.4 percent per year in China in the 1990s by adding to capital formation. See Wanda Tseng and Harm Zebregs, "Foreign Direct Investment in China: Some Lessons for Other Countries," IMF Policy Discussion Paper PDP/02/3 (February 2002). Other research emphasizes that FDI's effects on GDP growth are positive, but contingent on special conditions: the presence of a certain level of educational attainment (as proxy for a minimum level human capital development), or an open, export-promoting economic environment (but not an import-substituting one). See respectively, Borensztein *et al.* cited in endnote 7, and research by V.N. Balasubramanyam and others cited in the Asian Development Bank's *Asian Development Outlook 2004, Part 3 Foreign Direct Investment in Developing Asia*, Box 3.1 at pp. 220-221. For evidence of reverse causality between FDI and economic growth (in Chile) or bidirectional causality (in Malaysia and Thailand), see Abdhur Chowdhury and George Mavrotas, "FDI and Growth: What Causes What?" a paper presented at the Sharing Global Prosperity Conference, World Institute

for Development Economics Research, September 2003. For a useful summary, see Tony Addison and George Mavrotas, "Foreign Direct Investment, Innovative Sources of Development Finance and Domestic Resource Mobilization," mimeo, World Institute for Development Economics Research (August 2004). Some researchers hold that no direct and independent link exists between FDI and economic growth. For a study representative of the view that FDI is not an independent accelerator of economic growth, see Maria Carkovic and Ross Levine, "Does Foreign Direct Investment Accelerate Economic Growth?" mimeo, University of Minnesota (May 2002).

[9] See World Bank, Global Economic Prospects 2003, pp. 46-48, and UNCTAD's conclusions in World Trade Organization, Document WT/WGTI/W/8/Add.1, "Implications of the Relationship between Trade and Investment for Development and Economic Growth," pp. 14-16.

[10] For a summary of research and analysis of productivity-inducing effects of FDI, see Theodore H. Moran, *Parental Supervision: the New Paradigm for Foreign Direct Investment*, Washington DC: Institute for International Economics (2001), Chapter 2.

[11] See for example, Beata Smarzynska, "Does Foreign Direct Investment Increase the Productivity of Domestic Firms? In Search of Spillovers through Backward Linkages," World Bank Policy Research Paper 2923 (October 2002). This paper demonstrates positive vertical technology transfers from FDI to local suppliers in Lithuania. Additional research suggests that technology transfer can take the form of both vertical spillovers to suppliers and horizontal spillovers to domestic companies in the industry. See Liesbeth Dries and Johan F. M. Swinnen, "Foreign Direct Investment, Vertical Integration, and Local Suppliers: Evidence from the Polish Dairy Sector," in *World Development*, Volume 32, No. 9 (May 2004). Alternatively, Brian J. Aitken and Ann E. Harrison, "Do Domestic Firms Benefit from Direct Foreign Investment: Evidence from Venezuela" in *American Economic Review* Vol. 89, No. 3 (June 1999), find that FDI boosts productivity in (relatively smaller) joint venture operations, but that wholly owned domestic firms suffer negative spillovers—loss of market share—in the presence of FDI in the same industry. In Asia, the ADB surveys technology and productivity spillovers and finds that they are positive for the economy generally and for specific industries, but that the magnitude of the impacts varies and the rate of transfer is slow. The ADB underscores the importance of a policy framework maximizing research and development and training to leverage technology transfer opportunities of FDI. See ADB, *Asian Development Outlook 2004, Part 3 Foreign Direct Investment in Developing Asia*, at pp. 226-230.

[12] See Koji Miyamoto, "Human Capital Formation in Foreign Direct Investment in Developing Countries," OECD Development Center Working Paper No. 211 (July 2003), pp. 32-35. See also OECD "Mobilising Private Investment for Development: the Role of ODA," DCD/DAC (2004)/47 (December 2004), p. 8.

[13] OECD. "Foreign Direct Investment for Development, Maximising Benefits, Minimising Costs." Policy Brief (October 2002), pp. 3-4.

[14] Further, a sharp natural-resource induced rise in commodity exports could lead to a sustained increase in export revenues from extractive industries and give rise to the perverse "Dutch Disease" effect—a currency appreciation that renders other exports uncompetitive.

[15] See, for example, Prabhat Patnaik, "The Poverty of Theory," *Frontline*, Volume 18, Issue 06, March 17-30, 2001 at http://www.frontlineonnet.com/fl1806/18060150.htm.

[16] See Michael Klein, Carl Aaron, and Bita Hadjimichael, "Foreign Direct Investment and Poverty Reduction," World Bank Working Paper 2613, World Bank (undated). While FDI has many features that help generate growth and raise wages, it might not necessarily redistribute income toward the very poor, at least initially. FDI-based foreign affiliates tend to pay higher wages than local firms because they are relatively more productive. Increases in FDI flows might therefore widen the income gap between skilled workers employed in foreign affiliates and less skilled workers employed in local firms, or unemployed. But over time, so long as FDI-induced productivity improvements are diffused throughout the host economy, other workers would benefit and incomes would tend to again become more equal. *Ibid*, p. 4.

[17] See, for example, Jerome Levinson, "Certifying International Worker Rights: A Practical Alternative," Briefing Paper, Economic Policy Institute (June 1999).

[18] See, for example, Robert E. Lipsey and Fredrik Sjöholm, "Foreign Direct Investment, Education and Wages in Indonesian Manufacturing," *Journal of Development Economics*, 73 (2004), which demonstrates that for a worker with a given level of education, FDI-based firms tend to pay higher wages. The higher level of benefits and training offered workers in FDI-based enterprises is emphasized under Miyamoto, in endnote 12.

[19] See statements of International Labor Organization, Governing Body, Committee on Employment and Social Policy, "Trade Foreign Investment and Productive Employment in Developing Countries," GB.291/ESP/2 (September 2004).

[20] See Nick Mabey, Richard McNally, and Lyuba Zarsky, "Foreign Direct Investment and the Environment: From Pollution Havens to Sustainable Development," World Wide Fund for Nature-UK (July 2003), p. 5.

[21] See Lyuba Zarksy and Kevin Gallagher, "Searching for the Holy Grail? Making FDI Work for Sustainable Development," World Wide Fund for Nature, Gland, Switzerland (March 2003).

CHAPTER 3

[1] The discussion that follows adopts the World Bank definition of "developing countries." Under it, only "low-income" and "middle-income" countries are included, namely 155 economies with per capita Gross National Income (GNI) levels of $9,385 or below in 2003. This eliminates countries classified as "developing" by the United Nations, namely Singapore, Hong Kong China, Korea, Brunei, Taiwan, Cyprus, Kuwait, Qatar, UAE, Barbados, Bermuda, and Cayman Islands.

[2] Data for this chapter are from UNCTAD, *WIR 2004*, and World Bank, *GDF 2004*. Note that *WIR 2004* data are expressed in terms of total "FDI inflows," while *GDF 2004* data are based on "net FDI flows." *WIR 2004* data have been adjusted to conform to the more restrictive definition of developing countries explained in endnote 1.

[3] The World Bank forecasts net FDI flows to the developing world to rise by 13 percent and 8 percent in 2004 and 2005 respectively, to reach $165 billion by the end of 2005 (*GDF 2004*, pp. 96-100). UNCTAD's Global Investment Prospects Assessment of 335 of the world's largest multinationals, plus international FDI experts and a worldwide sample of investment promotion agencies is summarized in *WIR 2004*, pp. 32-35. Various private surveys of business confidence and investment sentiment for emerging markets are also reported there.

[4] See for example, Geng Xiao, "Round-Tripping Foreign Direct Investment in the People's Republic of China: Scale Causes and Implications," ADB Institute Discussion Paper No. 7 (June 2004), p. 21.

[5] By way of comparison to the developed world, Luxembourg recorded the world's largest FDI inflow in 2003 with $89 billion, but most of this appears to be "transshipped" investment through that nation's financial sector. France, with $47 billion in inflows, Belgium and the United States, with about $30 billion each, and Spain and Ireland, each with about $26 billion, are the developed country leaders in FDI inflows in 2003. Note that in 2000, at the height of the global FDI boom, the United States accounted for $314 billion in FDI inflows, the largest flow ever. See www.unctad.org/fdistatistics for UNCTAD data.

[6] *WIR 2004*, p. xix.

[7] The projections of net FDI flows by region for 2004-2005 offered in this section are drawn from *GDF 2004*, pp. 96-99.

CHAPTER 4

[1] The analysis of inward FDI stock is based on data reported in *WIR 2004*, Annex tables A.I.18 and A.I.20. Note that these data are built on the broader UN definition of developing countries and thus include inward FDI stock for Hong Kong, Singapore, and other relatively high-income countries. Note also that at any one moment, the FDI "stock" for a given country is essentially the sum of the inflows of the three components of FDI (equity, reinvested earnings, intracompany debt) that have accumulated up to that point in the country.

[2] There is some anecdotal evidence that a large share of this increase in business services may be due to the growth of holding companies and special purpose entities in Hong Kong and Caribbean island nations. See OECD, "Trends and Recent Developments in Foreign Direct Investment," Annex 1, Trends in ODA and Private Investment June 2004.

[3] *WIR 2004*, p. 71.

[4] *Ibid*. pp. 95-96.

[5] *Ibid*. pp. 29-31.

[6] Such considerations may explain some of the changes in the stock of textile, clothing, and leather industry FDI signaled earlier.

[7] In the post-quota world, tariffs will remain. But while developed countries' tariffs on textiles and apparel are high, they are not prohibitive and provide only a thin margin of preference for goods entering large, developed-country markets such as the United States under NAFTA and unilateral trade preferences (e.g., Caribbean Basin Economic Recovery Act, Andean Trade Preference and Drug Eradication Act, and African Growth and Opportunity Act), margins that may be less significant than the production cost advantages of large Asian suppliers. Moreover, special qualifying rules for apparel under unilateral preferential tariff arrangements often require the use of more expensive U.S fabric, further eroding the attractiveness of countries eligible for such preferences, unless they meet or beat the production costs in non-beneficiary countries, or present other special advantages (e.g., just-in-time capability).

[8] *GDF 2004*, pp.81-82.

[9] Vincent Palmade and Andrea Anayiotas, "FDI Trends, Looking Beyond the Current Gloom in Developing Countries" (September 2004) at http://rru.worldbank.org/PublicPolicyJournal.

CHAPTER 5

[1] This assumes that preconditions for FDI are met: favorable macroeconomic circumstances in world markets and sound balance sheets and good profit perspectives among multinationals considering investment.

[2] For examples, see IMF, Capital Markets Consultative Working Group, "Foreign Direct Investment in Emerging Market Countries" (September 2003), pp. 15-19; OECD, "Checklist for Foreign Direct Investment Incentive Policies" (2003), pp. 7-9; *WIR 2003*, p. 85; and OECD, Development Assistance Committee, "Mobilising Private Assistance for Development: the Role of ODA," DCD/DAC (2004) 47, pp. 8-13.

[3] *World Development Report 2005– A Better Investment Climate for Everyone*, World Bank (September 2004), p. 4.

[4] For domestic enterprises, this point is reflected in a recent assessment of enterprise growth that concluded, for example, that efforts to accelerate increases in productivity in the private sector can work, but should not be undertaken without addressing investment climate policy issues. See Development Alternatives, "Enterprise Growth Initiatives: Strategic Directions and Options" (February 2004).

[5] For example, one analysis concludes that a country's long-term economic performance is shaped primarily by social infrastructure— "institutions and government policies that determine the economic environment within which individuals accumulate skills, and firms accumulate capital and produce output." See Robert E. Hall and Charles I. Jones, "Why do some countries produce so much more output per worker than others?" *The Quarterly Journal of Economics* (February 1999). Empirical research also shows that "good governance," characterized by "policies promoting competition on a domestic and international level, as well as by open and transparent legal and regulatory regimes, and effective delivery of government services," is an important determinant of FDI. See Steven Globerman and Daniel Shapiro, "Global Foreign Direct Investment Flows: the Role of Governance Infrastructure," *World Development* (2002), Vol. 30, No 11.

[6] The relative weight of investment climate components in a multinational's investment decision depends on other factors such as the investor's objectives, the investment sector, and the uniqueness of the location. For example, a mining company seeking coltan, an ore refined to make a coating for electronics, is likely to invest in the Democratic Republic of the Congo in spite of macroeconomic and political instability because few other countries have this resource. Similarly, a financial services company might be willing to endure the restrictions of China's legal and regulatory framework in order to access a vast market. The less unique a location's offerings, however, the greater the competition it will face for FDI and the more important its general investment climate.

[7] John Williamson, "From Reform Agenda to Damaged Brand Name—A Short History of the Washington Consensus and Suggestions for What To Do Next," *Finance and Development*, September 2003.

[8] UNCTAD, "Economic Development and Capital Accumulation—An Interactive Thematic Session," June 2004; Heinz-Peter Elstrodt, Pablo Ordorica Lenero, and Eduardo Urdapilleta, "Micro lessons for Argentina," *The McKinsey Quarterly*, July 25, 2004; Michael E. Porter, World Economic Forum, *Global Competitiveness Report 2002-2003*.

[9] See, for example, IMF, Capital Markets Consultative Working Group, "Foreign Direct Investment in Emerging Market Countries" (September 2003), p. 17.

[10] See Tony Addison and Almas Hashmati, "The New Global Determinants of FDI Flows to Developing Countries—The Importance of ICT and Democratization," World Institute for Development Economics Research, Discussion Paper No. 2003/45 (May 2003).

[11] OECD, "Foreign Direct Investment for Development, Maximising Benefits, Minimising Costs—Overview" (2002), p. 27.

[12] OECD recently analyzed the principal investment scoreboards. In addition, it estimated empirical models designed to explain "inward FDI positions in developing countries by means of basic macroeconomic variables and four of the investment scoreboards." The results seemed to "confirm the conventional macroeconomic wisdom about the factors driving FDI" (e.g., population and GDP growth). But they also suggest that large segments of the scoreboards have little predictive power regarding countries' ability to attract FDI. See OECD, Development Assistance Committee, "Mobilising Private Assistance for Development: the Role of ODA— Annex 2: What guidance can be drawn for investment climate scoreboards?" DCD/DAC (2004)4/ANN2.

[13] See *The Economist*, September 8, 2004; *The Wall Street Journal*, October 8, 2003; *Oxford Analytica*, October 24, 2003; *The Hindu Business Line*, India, October 20, 2003.

[14] With USAID support, several other nations will be added to the survey for 2005, including Afghanistan.

[15] OECD is preparing a Policy Framework for Investment—"a non-prescriptive checklist of issues" to inform regional and national initiatives and dialogue on investment climate reform. The framework is expected to be issued in 2006.

[16] *World Development Report 2005—A Better Investment Climate for Everyone*, World Bank (2004), pp. 12-13.

[17] *Ibid*. Box 5.5 "One-stop shops-or one more stop shops?" p. 101.

[18] See Jacques Morisset and Olivier Lumenga Neso, "Administrative Barriers to Foreign Investment in Developing Countries," World Bank Policy Research Working Paper (May 2002).

[19] All EPZs seek to improve the performance of companies within them, but with different tools. Traditional EPZs are isolated from the surrounding economy, enjoy substantial duty exemptions and tax incentives, and emphasize export earnings and low-wage, low-skill jobs. A second type provides superior infrastructure to adopt technology which, in turn, attracts foreign and domestic investment that strengthens an entire industry or subsector (e.g., Taiwan's science parks). A third type provides a setting for policy experiments (e.g., through its special economic zones, China has tested and refined reform policies before introducing them elsewhere).

[20] *World Development Report 2005—A Better Investment Climate for Everyone*, pp. 167.

[21] The WTO's Agreement on Subsidies and Countervailing Measures (SCM) ties rules on acceptable policies within EPZs to country income. Least-developed countries may retain export performance subsidies as long as they remain under the income threshold of the SCM Agreement. Nonetheless, a number of developing countries are above the thresholds defined in the agreement, and their EPZ policies may be in violation of it.

[22] See summary and survey of the benefits of EPZs in World Bank, *Global Economic Prospects 2003*, pp. 83-85.

[23] *Ibid*. p. 81.

[24] OECD, "Checklist for Foreign Direct Investment Polices" (2003), p. 13 (footnote 7).

[25] IMF, Capital Markets Consultative Working Group, "Foreign Direct Investment in Emerging Market Countries" (September 2003), p. 17.

[26] While "export platform" efficiency-seeking FDI may be the most sensitive to tax incentives, Indonesia's experience is that even after tax incentives were eliminated in 1984, FDI inflows rose sharply. See Louis T. Wells Jr., Nancy J. Allen, Jacques Morisset, and Neda Pirnia, "Using Tax Incentives to Compete for Foreign Investment: Are They Worth the Costs?" FIAS Occasional Paper 15 (2002).

[27] Offered after an analysis of tax incentives in the SADC region. See Nathan Associates, "Effectiveness and Economic Impact of Tax Incentives in the SADC Region" (February 2004), p. xv. This study reviews tax incentives in Ireland, Malaysia, Costa Rica, and Mauritius, underscoring the costs and the difficulties of unequivocally associating investment results with incentives.

[28] Louis T. Wells, Jr. and Alvin G. Wint, "Marketing a Country: Promotion as a Tool for Attracting Foreign Investment," Foreign Investment Advisory Service, Occasional Paper No. 1, International Finance Corporation/Multilateral Investment Guarantee Agency, Washington, D.C., 1991. Revised version of this monograph is FIAS' Occasional Paper No. 13, published in 2000.

[29] The data cited here are drawn largely from UNCTAD, *The World of Investment Promotion at a Glance—A Survey of Investment Promotion Practices*, ASIT Advisory Studies, No. 17 (2001).

[30] *World Development Report 2005—A Better Investment Climate for Everyone*, World Bank, p. 171.

[31] Jacques Morisset and Kelly Andrews-Johnson, "The Effectiveness of Promotion Agencies at Attracting Foreign Direct Investment," Foreign Investment Advisory Service, Occasional Paper No. 16, International Finance Corporation/Multilateral Investment Guarantee Agency, Washington, D.C., (2004), p. 7.

[32] Multilateral Investment Guarantee Agency, "Creating an Aftercare Program, Investment Marketing Services." The high proportion of FDI generated from aftercare of existing investors refers to MIGA's analysis of experience in investment promotion in Ireland and Scotland, but the point is valid more generally: satisfied investors are a natural source of expansion, reinvestment, and diversification projects. The paper is available online to members at http://www.fdipromotion.com/toolkit/Documents/1/AFTERCARE_and_Management_of_expansion_projects-final.pdf.

[33] See Jacques Morisset, "Does a Country Need a Promotion Agency to Attract Foreign Direct Investment? A small analytical model applied to 58 countries," World Bank Policy Research Working Paper 3028 (April 2003).

[34] UNCTAD, "Good Governance in Investment Promotion," TD/B/COM/.2/EM.15/2 (August 2004), pp. 11-12.

[35] *World Development Report 2005–A Better Investment Climate for Everyone*, World Bank, Box 8.12, p. 172.

CHAPTER 6

[1] BITs typically use a broad definition of investment, including tangible and intangible assets and direct and portfolio investments, and apply to new and existing investments. They encourage the entry and establishment of investment, subject to the national law of the host government. Most BITs provide standards of treatment once an investment has been established, though many contain limited exceptions. They stipulate conditions and procedures for expropriation or nationalization, including compensation. Many BITs contain provisions on the transfer of payments, such as repatriation of profits. Finally, BITs include provisions for the resolution of disputes between a state and investors of the other state and between the states themselves. Most BITs also prohibit "performance requirements," such as a requirement to export a certain proportion of production or to use certain domestic inputs.

[2] http://www.unctad.org/en/docs/c2em11d2_en.pdf

[3] http://www.unctadxi.org/templates/Page____1007.aspx

[4] At the end of 2004, the United States had 39 BITs in effect and 8 others awaiting ratification. Overall, western European countries have concluded the most BITs, though China ranks third after Germany and Switzerland. The United States ranks about 25th.

[5] Although countries generally seek FDI and often extend positive incentives (e.g., tax holidays or tariff exemptions on capital goods or raw materials) to attract it, many also continue to adopt policies that impede investment. Such policies include exclusion of FDI from certain sector ("negative lists"), cumbersome or arbitrary screening procedures for foreign investors, limits on percentage of foreign ownership, domestic content requirements for intermediate inputs, employment restrictions, export balancing, restraints on remittance of profits, or even nationalization or expropriation. These restrictions may arise from a desire to protect domestic interests from competition or to maintain state-run monopolies, but their economic effects are negative.

[6] http://www.wto.org/english/tratop_e/region_e/region_e.htm

[7] The provisions vary among the agreements. For example, the US-Australia FTA does not provide for investor–state dispute settlement.

[8] Other RIAs contain less than the full array of BIT rules or explicitly discriminate against third-party investors. The first regional efforts to introduce rules on investment emphasized only free movement of capital and the right to set up and manage subsidiaries or agencies to pursue economic activity. The Treaty Establishing the Caribbean Community (1973) takes such an approach, as does the Treaty Establishing the African Economic Community (1991) and the Treaty Establishing the Common Market for Eastern and Southern Africa (1993). In contrast, the MERCOSUR states' investment policies have emphasized development and export promotion rather than economic efficiency. They have adopted a protocol explicitly limiting the rights of third-party investors, and the protocol contains no disciplines on performance requirements. The Andean Community and ASEAN have schemes to promote the creation of enterprises owned jointly by member country investors and extend preferential treatment to such enterprises.

[9] These include the Canada-Chile FTA (1997), the revised convention establishing the European Free Trade Association (2000), the Japan-Singapore Economic Partnership Agreement (2002), and the current draft of the FTAA. The Asia-Pacific Economic Cooperation's Non-binding Investment Principles (1994) incorporate NAFTA-like provisions without a binding dispute settlement mechanism. The Cotonou Agreement between the EU and the African, Caribbean, and Pacific States (2000) contains only general principles on investment but envisages the negotiation of side BITs among signatories.

[10] The WGTI's future is unclear. It could resume the analytical work it began after the Singapore conference, continue its preparatory work if negotiations begin at some date after the conclusion of the DDA round, or it could simply disband, as several developing countries advocate. Major controversies in WGTI discussions in recent years have involved, among other things, definitions of "investment" and "investor," transparency, technical assistance, and development provisions.

[11] Other efforts to establish a multilateral investment accord have also failed. In May 1995 ministers of the 29 developed country members of the OECD launched negotiations for a multilateral agreement on investment. The three pillars of the negotiations were a broad multilateral framework for investor protection, the liberalization of restrictions on investment, and an effective dispute settlement mechanism. Negotiators anticipated that developing countries might join the agreement once it was final. Although negotiations made significant progress in refining basic investment principles, participants agreed to suspend negotiations in October 1998, in light of significant differences on a number of issues (such as treatment of regional economic integration organizations and disciplines on

investment incentives) and the need for further consideration of concerns raised by environment and labor interests. The parties terminated negotiations in December 1998.

[12] Nonetheless, several developed countries (e.g., Japan, Canada, Australia) have not aggressively pursued BITs. China, on the other hand, is a major BIT participant, including with other developing countries, possibly to facilitate a strategy to establish textile and apparel manufacturing operations in other developing countries to better mine the global textile quota system. Other developing countries also participate in many BITs.

[13] See World Bank, "Do BITs increase investment flows? Only a bit," in *Global Economic Prospects and the Developing Countries*, September 2003, p. 129.

[14] World Bank Trade Note, "From Singapore to Cancun: Investment," May 29, 2003.

[15] Stein, Ernesto and Christian Daude, 2001, "Institutions, Integration and Location of Foreign Direct Investment" in *New Horizons for Foreign Direct Investment*, pp. 101-128. Paris: OECD. See also Jaumotte, Florence, "Foreign Direct Investment and Regional Trade Agreements: The Market Size Effect Revisited" IMF Working Paper WP/04/206. Washington: IMF.

[16] In an analysis of shareholder rights, creditor rights, efficiency of judiciary, rule of law and absence of corruption, Mexico scores below the Latin American average in four of five measures. Based on López-de-Silanes, "NAFTA and Mexico's Reforms on Investor Protection" as cited in Lederman, Maloney, and Servén, *Lessons from NAFTA for Latin America and the Caribbean* (Washington DC: World Bank, 2003), p. 199.

[17] A recent World Bank study concludes, for example, that Mexico in joining NAFTA and Spain and Portugal in joining the EU experienced a temporary increase in FDI. But the study found no clear evidence that the increased FDI that flowed to those countries was diverted from other developing countries in their regions. Rather, the study found the relative flows of FDI among RIA beneficiary countries in a given region seemed to correlate more closely with such factors as productivity growth, market openness and size, monetary and price stability, tax burden, and governance and institutional quality. See Lederman, Maloney and Servén, *Lessons from NAFTA for Latin America and the Caribbean*, Chapter 8, "The Impact of NAFTA on Foreign Investment in Third Countries," Washington DC: World Bank, 2003.

[18] http://www.unctad.org/sections/dite_pcbb/docs/webiteiit20042_en.pdf. Argentina faces the largest number of arbitration cases (37), largely resulting from actions taken during and after its 2001 financial crisis. It is followed by Mexico. In October 2004, the Government of Argentina issued a dismissal of all claims against it at the World Bank Group's International Centre for Settlement of Investor Disputes. Even excluding all Argentine claims to date, the number of dispute settlement cases is on the rise. The United States has been the defendant in 10 cases under NAFTA. Other countries facing multiple cases include Canada, Chile, Czech Republic, and Ukraine. Some claims involve large sums. In 2003 the Czech Republic was ordered to pay more than $270 million to a Dutch firm, and in 2002 a firm's claim against Ecuador resulted in a $71 million award. Not all claims are successful; defending states have won a significant number of cases.

[19] Signed in 1998, the Framework Agreement on the ASEAN Investment Area (AIA) seeks to raise FDI in ASEAN through the creation of a liberal and transparent investment environment, leading to fully open investment flows by 2020. Member states have agreed to undertake programs in investment liberalization, cooperation and facilitation, and investment promotion. AIA focuses on manufacturing, agriculture, forestry, fisheries and mining and quarrying, but with increasing interest in expanding coverage to a broad range of growing services (e.g., health care, tourism, telecommunications, distribution and logistics, transportation and others).

[20] http://www.ecattrade.com/issues/content.asp?ID=426

[21] All resources can be accessed through MIGA's website at http://www.miga.org.

[22] IFC has the added value of catalyzing FDI by use of its own resources. It is estimated that on average, for every $1 of IFC financing, other investors and lenders provide more than $5. IFC also syndicates loans with international commercial banks, underwrites investment funds, and provides business advisory services.

[23] See *World Development Report 2005 – A Better Investment Climate for Everyone*, World Bank, p.179.

APPENDIX A
Data on FDI Flows and Stocks

Table A-1

Distribution of FDI Inflows by Region and Country Income Group, 1970, 1980, and 1990–2003 (US$ billion)

	1970	1980	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Developing Countries [a]	3.0	5.5	25.6	33.9	47.2	71.8	94.3	108.2	133.9	181.1	178.8	188.4	167.8	178.8	157.9	145.5
Middle income	2.6	5.1	23.5	30.6	43.4	66.1	87.2	99.5	123.5	167.6	166.7	175.6	157.9	165.1	144.3	128.0
Upper middle income	1.5	2.7	12.8	18.4	21.9	23.8	36.1	40.1	54.0	82.3	87.4	106.7	96.1	82.2	62.5	47.0
Lower middle income	1.1	2.4	10.7	12.2	21.5	42.3	51.1	59.3	69.5	85.3	79.3	68.9	61.8	82.9	81.8	81.0
Low income	0.4	0.4	2.2	3.3	3.8	5.7	7.1	8.8	10.5	13.5	12.1	12.8	9.9	13.6	13.6	17.5
For reference: UN LDCs	-0.2	0.5	0.6	1.6	1.5	1.7	1.1	1.7	2.2	3.4	4.5	5.7	3.8	6.5	5.8	7.4
East Asia and the Pacific	0.4	1.4	11.2	13.4	21.7	39.7	45.9	54.4	62.7	65.7	60.6	52.5	46.5	51.1	60.7	59.5
Middle income	0.2	1.3	10.5	12.5	20.9	38.4	43.5	51.4	59.2	61.5	57.8	50.2	44.7	49.3	59.0	57.6
Upper middle income	0.1	0.9	2.6	4.0	5.1	5.7	4.6	5.8	7.3	6.3	2.7	3.9	3.8	0.6	3.2	2.5
Lower middle income	0.1	0.4	7.8	8.5	15.8	32.7	39.0	45.6	51.9	55.2	55.1	46.3	40.9	48.8	55.8	55.1
Low income	0.1	0.1	0.8	0.8	0.8	1.3	2.4	2.9	3.5	4.2	2.8	2.4	1.8	1.8	1.6	1.9
Europe and Central Asia	0.1	0.0	1.3	3.3	5.5	9.0	7.7	17.7	17.3	24.6	28.0	29.7	30.2	32.8	35.2	27.4
Middle income	0.1	0.0	1.3	3.3	5.5	9.0	7.6	17.6	17.1	24.3	27.7	29.5	30.0	32.6	34.9	27.3
Upper middle income	0.0	0.0	0.6	2.4	3.4	5.3	4.7	12.2	10.8	12.3	17.4	19.9	21.3	19.6	22.1	13.0
Lower middle income	0.1	0.0	0.7	0.9	2.1	3.7	2.8	5.4	6.3	12.0	10.3	9.6	8.7	13.0	12.8	14.3
Low income	0.0	0.0	0.0	0.0	0.0	0.1	0.1	0.1	0.2	0.3	0.3	0.2	0.2	0.2	0.2	0.2
Latin America and the Caribbean	1.5	6.5	8.6	13.0	14.8	14.6	32.6	29.6	45.7	71.2	72.5	91.6	79.6	70.5	45.6	36.2
Middle income	1.5	6.5	8.5	13.0	14.7	14.5	32.6	29.5	45.6	71.0	72.3	91.3	79.4	70.4	45.4	36.0
Upper middle income	1.1	5.8	7.2	11.7	13.0	11.6	26.5	24.2	37.4	60.6	62.6	83.6	72.4	61.8	36.9	29.8
Lower middle income	0.4	0.6	1.3	1.3	1.7	3.0	6.1	5.3	8.2	10.5	9.8	7.7	6.9	8.6	8.5	6.2
Low income	0.0	0.0	0.0	0.1	0.0	0.0	0.0	0.1	0.1	0.2	0.2	0.3	0.3	0.2	0.2	0.2
Middle East and North Africa	0.5	-2.8	2.8	1.6	2.4	5.1	2.9	-0.6	0.7	6.4	7.5	2.5	2.1	5.7	3.1	5.7
Middle income	0.4	-2.8	2.9	1.3	1.7	4.2	2.9	-0.4	0.7	6.6	7.8	2.8	2.1	5.6	3.0	5.8
Upper middle income	0.3	-4.2	2.2	0.4	0.1	1.6	0.4	-1.9	-1.1	3.2	4.5	-0.6	-1.7	0.3	-0.4	1.4
Lower middle income	0.1	1.3	0.8	0.9	1.6	2.6	2.5	1.5	1.8	3.4	3.3	3.4	3.8	5.3	3.5	4.4
Low income	0.0	0.0	-0.1	0.3	0.7	0.9	0.0	-0.2	-0.1	-0.1	-0.2	-0.3	0.0	0.1	0.1	-0.1
South Asia	0.1	0.2	0.5	0.4	0.7	1.1	1.6	3.0	3.6	4.9	3.5	3.1	3.1	4.0	4.5	6.1
Middle Income	0.0	0.0	0.0	0.1	0.1	0.2	0.2	0.1	0.1	0.4	0.2	0.2	0.2	0.1	0.2	0.2
Upper middle income	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Lower middle income	0.0	0.0	0.0	0.1	0.1	0.2	0.2	0.1	0.1	0.4	0.2	0.2	0.2	0.1	0.2	0.2
Low income	0.1	0.2	0.5	0.3	0.6	0.9	1.4	2.9	3.5	4.5	3.3	2.9	2.9	3.9	4.3	5.8
Sub-Saharan Africa	0.5	0.3	1.2	2.2	1.9	2.3	3.6	4.2	3.9	8.3	6.6	8.9	6.2	14.7	8.9	10.6
Middle income	0.3	0.2	0.2	0.4	0.4	-0.2	0.5	1.3	0.6	3.8	1.0	1.6	1.5	7.3	1.7	1.2
Upper middle income	0.0	0.2	0.2	0.0	0.1	-0.4	-0.1	-0.2	-0.3	-0.1	0.3	-0.1	0.3	0.0	0.7	0.3
Lower middle income	0.3	0.0	0.0	0.5	0.2	0.1	0.5	1.5	1.0	3.9	0.8	1.7	1.2	7.2	1.0	0.9
Low income	0.2	0.1	1.0	1.8	1.6	2.5	3.1	3.0	3.3	4.5	5.6	7.3	4.7	7.4	7.1	9.4

[a] Low and middle-income countries according to World Bank classifications (2003 per capita GNI $9,385 or below). Regional groupings according to World Bank definitions. Based on these criteria certain countries that UNCTAD considers developing (e.g., Singapore, Hong Kong, Korea, Cayman Islands, Bermuda, Brunei, Barbados, Cyprus, Taiwan, Kuwait, Qatar, and UAE) the World Bank considers high-income.

SOURCE: UNCTAD, *World Investment Report 2004*; World Bank, *World Development Report 2005*.

Table A-2

Estimated Value of Inward FDI Stock, by Sector and Industry, for Developing and Developed Countries, 1990 and 2002 ($ billion)

	1990			2002				
Sector and Industry	Developing Countries	Developed Countries	World	Developing Countries	Central and Eastern Europe	Developing Countries (adj.)[a]	Developed Countries	World
Primary								
Agriculture, hunting, forestry and fishing	4.0	3.6	7.6	19.0	0.9	19.9	7.6	27.5
Mining, quarrying and petroleum	16.8	155.8	172.6	125.8	6.0	131.9	289.6	421.4
Unspecified	2.3	0.0	2.3	0.0	0.0	0.0	0.0	0.0
Subtotal	23.1	159.4	182.5	144.8	6.9	151.7	297.2	448.9
Manufacturing								
Food, beverages and tobacco	10.1	73.1	83.2	29.2	19.0	48.2	143.8	192.0
Textiles, clothing and leather	5.4	24.4	29.8	9.1	2.0	11.1	41.3	52.3
Wood and wood products	4.8	20.9	25.8	16.7	8.2	24.9	53.1	78.1
Publishing, printing, reproduction of recorded media	0.5	15.8	16.3	0.3	0.5	0.8	70.7	71.5
Coke, petroleum products and nuclear fuel	3.5	56.3	59.8	10.1	0.9	11.0	33.2	44.2
Chemicals and chemical products	49.1	126.4	175.5	70.9	8.8	79.7	338.5	418.2
Rubber and plastic products	2.7	13.4	16.0	4.6	3.2	7.8	26.2	34.0
Non-metallic mineral products	3.0	17.5	20.6	6.5	8.6	15.1	49.0	64.1
Metal and metal products	16.5	51.9	68.5	26.4	4.3	30.7	119.7	150.4
Machinery and equipment	9.8	49.0	58.8	24.5	4.4	28.9	98.4	127.3
Electrical and electronic equipment	19.0	74.7	93.7	62.1	9.3	71.4	216.6	287.9
Precision instruments	0.5	12.4	12.9	2.4	0.3	2.7	25.2	27.9
Motor vehicles/other transport equipment	8.9	49.2	58.1	21.3	15.9	37.2	214.5	251.7
Other manufacturing	2.9	19.4	22.2	10.6	0.6	11.2	52.9	64.1
Unspecified secondary	19.2	46.4	65.6	455.4	4.4	459.8	118.9	578.7
Subtotal	155.9	651.0	806.9	750.2	90.4	840.6	1,601.9	2,442.6

Table A-2 (continued)

Sector and Industry	1990			2002				
	Developing Countries	Developed Countries	World	Developing Countries	Central and Eastern Europe	Developing Countries (adj.)[a]	Developed Countries	World
Services								
Electricity, gas and water	3.1	7.0	10.1	45.5	8.5	53.9	89.9	143.9
Construction	5.2	17.5	22.6	33.6	6.2	39.9	35.6	75.4
Trade	24.2	209.2	233.3	148.3	28.4	176.7	617.1	793.7
Hotels and restaurants	3.2	22.2	25.4	19.8	2.5	22.3	53.0	75.3
Transport, storage and communications	12.3	16.7	29.0	105.7	32.2	137.9	338.2	476.1
Finance	92.9	289.5	382.5	246.3	39.1	285.4	963.5	1,249.0
Business services	8.3	117.5	125.8	434.1	13.5	447.6	703.1	1,150.7
Public administration and defense	0.0	0.0	0.0	0.1	0.0	0.1	6.5	6.6
Education	0.0	0.1	0.1	0.0	0.0	0.0	0.4	0.4
Health and health services	0.0	1.0	1.0	4.1	0.1	4.2	8.4	12.6
Community, social and personal services	0.0	14.0	14.0	5.4	1.1	6.6	62.9	69.5
Other services	13.1	75.7	88.8	38.2	3.1	41.4	63.7	105.0
Unspecified tertiary	1.2	14.4	15.617.4	0.0	17.4	187.8	205.2	
Subtotal	163.3	784.8	948.1	1,098.5	134.8	1,233.4	3,130.0	4,363.4
Private buying and selling of property	0.0	0.0	0.0	0.0	0.7	0.7	1.2	1.9
Unspecified	3.6	9.2	12.8	69.2	8.3	77.5	37.4	114.8
TOTAL	346.0	1,604.4	1,950.3	2,062.7	241.1	2,303.9	5,067.7	7,371.6

[a] Developing countries and Central and Eastern Europe.

SOURCE: UNCTAD, *World Investment Report 2004*, Annex table A.I.18.

Table A-3

Estimated Distribution of Inward FDI Stock, by Sector and Industry, Developing Countries and Worldwide, and Developing Country Share of Worldwide Stock, 1990 and 2002

	Distribution of FDI (%)						Share of World FDI (%)			
	1990		2002				1990	2002		
Sector and Industry	Developing Countries	World	Developing Countries	Central and Eastern Europe	Developing Countries (adj.)[a]	World	Developing Countries	Developing Countries	Central and Eastern Europe	Developing Countries (adj)[a]
Primary										
Agriculture, hunting, forestry and fishing	1.1	0.4	0.9	0.4	0.9	0.4	52.0	69.1	3.3	72.4
Mining, quarrying and petroleum	4.8	8.8	6.1	2.5	5.7	5.7	9.7	29.9	1.4	31.3
Unspecified	0.7	0.1	0.0	0.0	0.0	0.0	100.0	--	--	--
Subtotal	6.7	9.4	7.0	2.9	6.6	6.1	12.6	32.3	1.5	33.8
Manufacturing										
Food, beverages and tobacco	2.9	4.3	1.4	7.9	2.1	2.6	12.1	15.2	9.9	25.1
Textiles, clothing and leather	1.6	1.5	0.4	0.8	0.5	0.7	18.2	17.4	3.8	21.1
Wood and wood products	1.4	1.3	0.8	3.4	1.1	1.1	18.7	21.4	10.5	31.9
Publishing, printing, reproduction of recorded media	0.1	0.8	0.0	0.2	0.0	1.0	3.1	0.4	0.7	1.1
Coke, petroleum products and nuclear fuel	1.0	3.1	0.5	0.4	0.5	0.6	5.8	22.9	2.0	24.9
Chemicals and chemical products	14.2	9.0	3.4	3.7	3.5	5.7	28.0	16.9	2.1	19.1
Rubber and plastic products	0.8	0.8	0.2	1.3	0.3	0.5	16.6	13.6	9.4	23.0
Non-metallic mineral products	0.9	1.1	0.3	3.5	0.7	0.9	14.8	10.2	13.3	23.5
Metal and metal products	4.8	3.5	1.3	1.8	1.3	2.0	24.1	17.6	2.9	20.4
Machinery and equipment	2.8	3.0	1.2	1.8	1.3	1.7	16.7	19.2	3.5	22.7
Electrical and electronic equipment	5.5	4.8	3.0	3.9	3.1	3.9	20.3	21.6	3.2	24.8
Precision instruments	0.2	0.7	0.1	0.1	0.1	0.4	4.1	8.8	1.0	9.8
Motor vehicles/other transport equipment	2.6	3.0	1.0	6.6	1.6	3.4	15.3	8.5	6.3	14.8
Other manufacturing	0.8	1.1	0.5	0.3	0.5	0.9	12.8	16.6	1.0	17.5
Unspecified secondary	5.5	3.4	22.1	1.8	20.0	7.9	29.3	78.7	0.8	79.4
Subtotal	45.1	41.4	36.4	37.5	36.5	33.1	19.3	30.7	3.7	34.4

Table A-3 (continued)

Sector and Industry	Distribution of FDI (%)						Share of World FDI (%)			
	1990		2002				1990	2002		
	Developing Countries	World	Developing Countries	Central and Eastern Europe	Developing Countries (adj.)a	World	Developing Countries	Developing Countries	Central and Eastern Europe	Developing Countries (adj)a
Services										
Electricity, gas and water	0.9	0.5	2.2	3.5	2.3	2.0	30.3	31.6	5.9	37.5
Construction	1.5	1.2	1.6	2.6	1.7	1.0	22.8	44.6	8.3	52.8
Trade	7.0	12.0	7.2	11.8	7.7	10.8	10.4	18.7	3.6	22.3
Hotels and restaurants	0.9	1.3	1.0	1.0	1.0	1.0	12.6	26.3	3.3	29.6
Transport, storage and communications	3.6	1.5	5.1	13.4	6.0	6.5	42.5	22.2	6.8	29.0
Finance	26.9	19.6	11.9	16.2	12.4	16.9	24.3	19.7	3.1	22.9
Business activities	2.4	6.4	21.0	5.6	19.4	15.6	6.6	37.7	1.2	38.9
Public administration and defense	0.0	0.0	0.0	0.0	0.0	0.1	--	1.3	0.1	1.4
Education	0.0	0.0	0.0	0.0	0.0	0.0	0.0	4.0	3.8	7.8
Health and health services	0.0	0.1	0.2	0.1	0.2	0.2	0.0	32.4	1.0	33.4
Community, social, and personal services	0.0	0.7	0.3	0.5	0.3	0.9	0.0	7.8	1.6	9.4
Other services	3.8	4.6	1.9	1.3	1.8	1.4	14.7	36.4	3.0	39.4
Unspecified tertiary	0.3	0.8	0.8	0.0	0.8	2.8	7.4	8.5	0.0	8.5
Subtotal	47.2	48.6	53.3	55.9	53.5	59.2	17.2	25.2	3.1	28.3
Private buying and selling of property	0.0	0.0	0.0	0.3	0.0	0.0	--	0.0	35.3	35.3
Unspecified	1.0	0.7	3.4	3.4	3.4	1.6	28.1	60.2	7.2	67.5
TOTAL	100.0	100.0	100.0	100.0	100.0	100.0	17.7	28.0	3.3	31.3

[a] Developing countries and Central and Eastern Europe.

SOURCE: UNCTAD, *World Investment Report 2004*, Annex table A.I.18.

APPENDIX B
Publications and Resources

Resource and Availability	Description
General Investment Flows and Trends	
Institute of International Finance Inc. 2003. Capital Flows to Emerging Market Economies. Available to members at http://www.iif.com/verify/data/report_docs/cf_0903.pdf	Discusses current capital flow activity and offers some forecasts.
International Monetary Fund. 2003. Foreign Direct Investment in Emerging Market Countries. Available at http://www.imf.org/external/np/cmcg/Working Group). 2003/eng/091803.pdf	Explains shifts in types of FDI (prepared by a Capital Markets Consultative Working Group).
Organisation for Economic Co-operation and Development (OECD). 2003. Trends and Recent Developments in Foreign Direct Investment. http://www.oecd.org/dataoecd/52/11/2958722.pdf	Covers slowdown in global FDI and its effect on OECD as well as developing countries.
United Nations Conference on Trade and Development (UNCTAD). 2000. Bilateral Investment Treaties Quintupled During the 1990s. Summary: http://r0.unctad.org/en/press/pr2877en.pdf Full study: http://www.unctad.org/en/docs/poiteiiad2.en.pdf	Describes growth in BITs and the top 25 countries for number of BITs.
UNCTAD. 2001. *World Investment Report: Promoting Linkages.* To order, go to http://www.unctad.org/Templates/WebFlyer.asp?intItemID=2434&lang=1	Covers linkages between foreign affiliates of multinational enterprises and local companies in developing countries.
UNCTAD. 2002. *World Investment Report: Transnational Corporations and Export Competitiveness.* To order, go to http://www.unctad.org/Templates/webflyer.asp?docid=2574&intItemID=2095&lang=1	Covers measures and analyzes trends in global and regional FDI, especially the role of transnational corporations in developing countries' export competitiveness. Includes statistical annex.
UNCTAD. 2003. *World Investment Report: FDI Policies for Development: National and International Perspectives.* To order, go to http://www.unctad.org/Templates/WebFlyer.asp?intItemID=2979&lang=1	Covers role of FDI policies and international agreements in attracting FDI and ensuring that developing countries benefit from it.

Resource and Availability	Description
UNCTAD. 2004. *World Investment Report: The Shift Towards Services.* To order go to: http://www.unctad.org/Templates/webflyer.asp?docid=5209&intItemID=1397&lang=1.	Covers growing trend toward investment services.
World Bank. 2003. *Global Economic Prospects and the Developing Countries: Investing to Unlock Global Opportunities.* Available at http://www.worldbank.org/prospects/gep2003/toc.htm	Reviews trends and developments that affect global and domestic dimensions of developing countries' investment climates.
World Bank. 2003. Recent Trends in Financial Flows to Developing Countries. Available at http://topics.developmentgateway.org/fdi/rc/ItemDetail.do~347390	Examines trends in financial flows (background note prepared for a Development Committee meeting of the World Bank in September 2003).
Multilateral Investment Guarantee Agency (MIGA)/World Bank. 2003. Shedding New Light on Africa's Investment Opportunities. Available at http://www.ipanet.com/documents/WorldBank/databases/africa/africa_newlight.pdf	Profiles opportunities in Africa brought about by new trading agreements, political risk packages, and other changes.

International Arrangements Affecting Investment

Cosby, Aaron, Howard Mann, Luke Peterson, and Konrad von Moltke. 2003. Investment, Doha, and the WTO. International Institute for Sustainable Development and the Royal Institute of International Affairs. Available at http://www.iisd.org/pdf/2003/investment_riia_iisd.pdf	Examines history of investment agreements from an environmental perspective, and assesses whether the WTO can deliver on investment issues.
Ferrarini, Benno, 2003. A Multilateral Framework for Investment? Bern, Switzerland: World Trade Institute. Available at http://www.cid.harvard.edu/cidtrade/Papers/ferrarini_wti_investment.pdf	Summarizes arguments in favor of a multilateral framework put forward by the EU and the United States, as well as the criticisms presented by India, the main opponent.
Hallward-Dreimeier, Mary. 2003. Do Bilateral Treaties Attract FDI? World Bank. Available at http://econ.worldbank.org/files/29143_wps3121.pdf	Explores the role of bilateral treaties in stimulating FDI.
Hoekman, Bernard, and Saggi, Kamal. 2002. Multilateral Disciplines and National Investment Policies. In *Development, Trade and the WTO: A Handbook.* The World Bank.	Surveys arguments for why developing countries should support adoption of a multilateral agreement on investment.
OECD. 2002. *The OECD Declaration and Decisions on International Investment and Multinational Enterprises: Basic Texts.* Available at http://www.oecd.org/document/28/0,2340,en_2649_34889_2397532_1_1_1_1,00.html	Covers OECD guidelines for multinational enterprises, national treatment, international investment incentives and disincentives, conflicting requirements.
Robertson, David. 2001. Export Processing Zones and the WTO Agreement on Subsidies and Countervailing Measures. In *International Tax Competition: Globalisation and Fiscal Sovereignty.* 2002. Edited by Rajiv Biswas. Commonwealth Secretariat: London.	Describes potential conflicts between the WTO's Agreement on Subsidies and Countervailing Measures and the incentive programs of developing countries' export processing zones.
Trade and Investment in the WTO. Available at: http://www.wto.org/english/tratop_e/invest_e/invest_e.htm	Background on the WTO Working Group on Trade and Investment, the TRIMS, and the GATS.

Resource and Availability	Description
Investment Climate	
Batra, Geeta, Daniel Kaufmann, and Andrew H. W. Stone. 2003. Investment Climate Around the World: Voices of the Firms from the World Business Environment Survey. World Bank. To order, go to http://publications.worldbank.org/ecommerce/catalog/product?item_id=1923391	Reports findings of World Business Environment Survey, a tool for evaluating investment climates. Reviews policy implications for 80 countries.
Christiansen, Hans. 2004. ODA and Investment for Development: What Guidance Can be Drawn from Investment Climate Scoreboards? OECD. Available at http://www.oecd.org/dataoecd/53/39/33803268.pdf	Evaluates the utility of investment climate scoreboards.
COMESA. Common Investment Area Regional Investors Roadmap. Available at http://www.comesa.int/investment/regimes/investment_area/	Seeks to understand how to increase cross-border investment in COMESA.
Morisset, Jacques and Olivier Lumenga Neso. 2002. Foreign Investment Advisory Service. Administrative Barriers to Foreign Investment in Developing Countries. World Bank. Available at http://econ.worldbank.org/files/15291_wps2848.pdf	Explains administrative barriers to starting up a business in developing countries and how these affect the attraction of FDI.
Proposal for the Establishment of a Regional Investment Agency for COMESA. Available at http://www.comesa.int/investment/regimes/investment_area/	Details rationale and justification for setting up a regional investment agency to promote investment in COMESA.
World Bank. 2004. *Doing Business in 2005: Removing Obstacles to Growth.* Can be viewed and purchased at http://rru.worldbank.org/doingbusiness/doingbusiness2005.aspx	Quantitative indicators and supporting text that inform foreign investors and domestic firms about the business regulatory environment and costs of doing business in more than 145 countries, with coverage to be expanded in 2005 and beyond.
World Bank. 2004. *World Development Report 2005: A Better Investment Climate for Everyone.* Available by searching http://publications.worldbank.org/ecommerce/	Argues that improving investment climates should be a top priority of governments and offers practical insights for policymakers, executives, and scholars.
Investment Promotion	
Drabek, Zdanek, and Warren Payne. 1999. The Impact of Transparency on Foreign Direct Investment. Staff Working Paper ERAD-99-02. Geneva: WTO. Search for title at http://www.wto.org/english/res_e/reser_e/wpaps_e.htm	Empirical investigation of the impact of non-transparent government policies on FDI inflows.
Foreign Investment Advisory Service (FIAS). Institutional Framework for Attracting FDI and the Importance of an Investment Promotion Strategy. http://www.fias.net/html/services_institutional_framework.htm	Describes importance of the organizational structure of an investment promotion agency.
Morisset, Jacques. 2003. Does a country need a promotion agency to attract foreign investment? A small analytical model applied to 58 countries. World Bank.	Econometric evaluation of the utility of investment promotion agencies.

Resource and Availability	Description
OECD. 2002. Attracting International Investment for Development. OECD Global Forum for International Investment. Available at http://www1.oecd.org/publications/e-book/1403041E.PDF	Covers policy principles for attracting FDI, a checklist for assessing FDI incentive policies, and recent OECD work in FDI incentives.
OECD. 2003. Checklist for Foreign Direct Investment Incentive Policies. Available at http://www.oecd.org/dataoecd/45/21/2506900.pdf	Provides a tool for assessing the usefulness and relevance of FDI incentive policies.
OECD. 2003. Policies Toward Attracting Foreign Direct Investment. Available at http://www.oecd.org/dataoecd/45/21/2506900.pdf	Conference papers from the 2002 OECD Global Forum on International Investment covering developmental impact of FDI, investment incentives, linkages, corporate citizenship, etc.
Te Velde, Dirk Willem. 2001. *Policies Towards Foreign Direct Investment in Developing Countries: Emerging Best-Practices and Outstanding Issues.* London: Overseas Development Institute.	Presents case studies of Singapore and Ireland.
United Nations Industrial Development Organization (UNIDO). 2003. *Guidelines for Investment Promotion Agencies: Foreign Direct Investment Flows to Developing Countries.* Available at http://www.unido.org/file-storage/download/?file_id=10543	Reviews best practices and lessons learned in investment policies and FDI promotion strategies based on UNIDO's tools, methodologies, and mechanisms for governments and private enterprises.
Wells, Louis and Alvin Wint. 2000. *Marketing a Country: Promotion as Tool for Attracting Foreign Investment.* FIAS. Search for title at http://hbswk.hbs.edu/item.jhtml?id=2153&t=globalization	Describes structure and functions of agencies that promote foreign investment. Discusses techniques used in competing for foreign investment.
Wells, Louis, Nancy J. Allen, Jacques Morisset, and Neda Pirnia. 2001. Using Tax Incentives to Compete for Foreign Investment: Are They Worth the Costs? Foreign Investment Advisory Service, Occasional Paper No. 15. Washington, DC: International Finance Corporation/Multilateral Investment Guarantee Agency.	Uses case studies to evaluate the costs and benefits of attracting FDI through tax incentives.
UNCTAD. 2001. The World of Investment Promotion at a Glance—A survey of investment promotion best practices. ASIT/UNCTAD Advisory Studies, No. 17.	Provides an overview of best practices in investment promotion.

Foreign Investment Impact

Aitken, Brian, G. Hanson, and A. Harrison. 1997. Spillovers, Foreign Investment and Export Behavior. *Journal of International Economics.* 43:103-132.	Investigates the hypothesis that multinational companies act as export catalysts. Uses panel data for 1986–1990 for 2,104 Mexican manufacturing plants.
Aitken, Brian, and A. Harrison. 1999. Do Domestic Firms Benefit from Foreign Direct Investment? *The American Economic Review.* 89(3): 605-618.	Uses panel regressions of more than 4,000 Venezuelan plants between 1976 and 1989 to investigate backward and forward linkage effects and spillovers in the same industry.
Anderson, Jock, Howard Barnum, Pedro Belli, John Dixon, and Jee Peng Tan. 2001. *Economic Analysis of Investment Operations: Analytical Tools and Practical Applications.* World Bank. Available for purchase at http://publications.worldbank.org/ecommerce/catalog/product-detail?product_id=219123&	Combines theory and practice and provides methodologies for project analysis and evaluation.

Resource and Availability	Description
Bende-Nabende, Anthony. 1998. A Static Analysis of the Impact of FDI on the Host Developing Countries' Economic Growth: A Case for the ASEAN-5 Economies. Presented at the ESRC Conference "Finance and Development," Birmingham, UK, September 7-8, 1998. Mimeo.	Investigates whether FDI has spillover effects that have led to economic growth in ASEAN-5 economies. Reviews theoretical and empirical literature on employment, human capital formation, technology transfer, and growth.
Blomstrom, Magnus, and Ari Kokko. 1996. The Impact of Foreign Investment on Host Countries: A Review of the Empirical Evidence. Policy Research Working Paper 1745. Washington DC: World Bank. Available at http://web.worldbank.org/external/default/WDSContentServer/IW3P/IB/2000/02/24/000009265_3971110141252/Rendered/PDF/multi_page.pdf	Reviews empirical evidence of effects of FDI on host countries.
Borenzstein, Eduardo, Jose De Gregorio, and Jong-Wha Lee. 1998. How does Foreign Direct Investment Affect Economic Growth? *Journal of International Economics.* 45:115-135.	Investigates effect of FDI on economic growth in a cross-country regression framework using FDI flow data to 69 developing countries for 1970–1989.
Caves, Richard. 1999. Spillovers from Multinationals in Developing Countries: The Mechanisms at Work. William Davidson Institute Working Paper 247. Michigan: William Davidson Institute. Available at http://www.bus.umich.edu/KresgeLibrary/Collections/WorkingPapers/wdi/wp247.pdf	Reviews theoretical and empirical literature on spillovers.
De Melo, Luiz R. Jr. 1999. Foreign Direct Investment–led Growth: Evidence from Time Series and Panel Data. 1999. *Oxford Economic Papers* 51(1).	Tests hypothesis of increasing returns due to FDI in five Latin American economies. Findings suggest that variables in the recipient country's trade regime affect FDI and growth in the long run.
Ekholm, Karolina, Rikard Forslid and James Markusen 2003. Export-Platform Foreign Direct Investment. NBER Working Paper No. w9517. To order, go to http://papers.nber.org/papers/W9517	Theoretical analysis of phenomenon of export-platform FDI, in which the affiliate's products are exported to a third market (as opposed to host or parent country).
Kokko, Ari. 1996. Productivity Spillovers from Competition Between Local Firms and Foreign Affiliates. *Journal of International Development* 8(4): 517-530.	Tests for productivity spillovers resulting from competition between local firms and foreign affiliates in the Mexican manufacturing sector.
Lall, Sanjaya. 1980. Vertical Interfirm Linkages in LDCs: An Empirical Study. *Oxford Bulletin of Economics and Statistics.* 42:203-226.	Investigates microeconomic determinants of backward linkages of India's two main truck manufacturers (one majority foreign-owned, the other majority domestic-owned), and their suppliers.
Lall, Sanjaya and Paul Streeten. 1977. *Foreign Investment, Transnationals, and Developing Countries.* Boulder, Colorado: Westview Press.	Cost-benefit analysis of effects of 88 foreign and locally owned projects on national income in six developing countries.
Moran, Theodore. 1998. *Foreign Direct Investment and Development.* Washington DC: Institute for International Economics. Available with password at http://www.iie.com/publications/bookstore/publication.cfm?pub_id=53	Synthesis of evidence from literature on FDI that suggests the need for a new agenda for host governments.

Resource and Availability	Description
Moran, Theodore. 2001. *Parental Supervision: The New Paradigm for Foreign Direct Investment and Development.* Washington, DC: Institute for International Economics. Available with password at http://www.iie.com/publications/bookstore/publication.cfm?pub_id=324	Investigates empirically whether the degree of foreign ownership of FDI (joint venture versus wholly owned subsidiary) influences the development impact of FDI.
OECD. 2002. *Foreign Direct Investment for Development: Maximising Benefits, Minimising Costs.* Available at http://www.oecd.org/dataoecd/61/12/2763043.pdf	Analyzes effect of FDI on macroeconomic growth, poverty, technology transfer, and other economic welfare-enhancing processes, and on the channels through which these benefits accrue.
Olunkole, Iyanla.1999. The impact of multinational enterprises on employment, training, and regional development in Namibia and Zimbabwe: A preliminary assessment. Working Paper No. 84. Geneva: Multinational Enterprises Programme. Available at http://www.ilo.org/public/english/employment/multi/download/wp84.pdf	Assesses the contribution of multinational enterprises to economic development in Namibia and Zambia.
Ramachandran, Vijaya, and Manju Kedia Shah. 1997. The Effects of Foreign Ownership in Africa: Evidence from Ghana, Kenya and Zimbabwe. RPED Paper No. 81. Washington, DC: World Bank.	Econometric analysis of impact of foreign ownership on firms in sub-Saharan Africa, based on firm-level data from Ghana, Kenya, and Zimbabwe.
Saggi, Kamal. Trade, Foreign Direct Investment, and International Technology Transfer: A Survey. Working Paper 2349. World Bank, May 2000. Available at http://econ.worldbank.org/files/1103_wps2349.pdf	Surveys literature on international technology transfer, especially role of FDI. Discusses diffusion of technology from multinationals to local firms and the effect of host-country policies on technology transfer.
Thomsen, Stephen. 1999. Southeast Asia: The Role of Foreign Direct Investment Policies in Development. Working Papers on International Investment. Paris: OECD. Available at http://www.oecd.org/dataoecd/5/24/1897793.pdf	Reviews role of FDI in economic development of Indonesia, Malaysia, the Philippines, and Thailand.
World Wildlife Fund. 2003. Searching for the Holy Grail? Making FDI Work for Sustainable Development. Available at http://www.ase.tufts.edu/gdae/publications/articles_reports/KG-LZ_FDI_report.pdf	Investigates the relationship between FDI flows, environment issues, and development.
Domestic Investment	
Agosin, Manuel and Ricardo Mayer. 2000. Foreign Investment in Developing Countries: Does it Crowd in Domestic Investment? UNCTAD. Available at http://www.unctad.org/en/docs/dp_146.en.pdf	Concludes that foreign investment may displace domestic investment.
Chen, Tain Jy and Yinh-Hua Ku. 2002. The Boomerang Effects of FDI on the Domestic Economy. In *Taiwan in the Global Economy: From an Agrarian Economy to an Exporter of High-Tech Products.* Edited by Peter Chow. Westport, CT: Praeger Publishers.	Explores Taiwan's use of FDI and domestic investment for broad-based and sector growth.
De Barker, Koen, and Sleuwaegen, Leo. 2002. Does Foreign Investment Crowd out Domestic Entrepreneurship? Economic Working Paper No. 618. Department of Economics and Business, Universitat Pompeu Fabra. Available at http://www.econ.upf.edu/docs/papers/downloads/618.pdf	Explores the short- and long-term implications of FDI for domestic entrepreneurship.

Resource and Availability	Description
Konings, Jozef. 2000. The Effects of Direct Foreign Investment on Domestic Firms: Evidence from Firm-level Panel Data in Emerging Economies. Working Paper no. 344. William Davidson Institute: University of Michigan. Available at http://www.bus.umich.edu/KresgeLibrary/Collections/WorkingPapers/wdi/wp344.pdf	Explores whether foreign firms perform better than domestic firms and whether they generate spillovers in Central and Eastern Europe.
Wang, Miao. FDI and Domestic Investment: Crowding In or Crowding Out? Available at http://www.uoregon.edu/~wangmiao/fdicrowdab.pdf	Discusses the types of foreign investment that may or may not crowd domestic investment.
Portfolio and Other Capital Investment	
Chuhan, Punam, Gabriel Perez-Quiros, and Helen Popper. 1996. International Capital Flows: Do Short-term Investment and Direct Investment Differ? Policy Research Working Paper 1669. Washington DC: World Bank. Available at http://econ.worldbank.org/files/833_wps1669.pdf	Empirical analysis of behavior of the four major components of capital flows in 15 developing and industrial countries.
Evans, Kimberly. 2002. Foreign Portfolio and Direct Investment: Complementarity, Differences, and Integration. Global Forum on Investment. Shanghai: OECD. Available at http://www.oecd.org/dataoecd/54/25/2764407.pdf	Explores how two forms of investment contribute to development.
Eichengreen, Barry. 2000. Taming Capital Flows. *World Development.* 28(6): 1105-1116.	Presents recommendations for developing country governments on managing high capital mobility and liberalizing capital markets.
Gacs, Janos, Robert Holzmann, and Michael Wyzan (eds.). 1999. *The Mixed Blessings of Financial Inflows: Transition Countries in Comparative Perspective.* International Institute for Applied Systems Analysis and Ludwig Boltzmann Institute for Economic Policy Analysis.	Describes the benefits of large capital inflows in transition countries as well as the challenges of such inflows for macroeconomic policy.
Kahler, Miles, Editor. 2002. *Capital Flows and Financial Crises.* Cornell University Press. Can be purchased at http://www.addall.com/detail/0801485622.html	Explores private capital flows and their consequences in developing countries.
World Bank. 2003. Foreign Investment, Remittances Outpace Debt as Sources of Finance for Developing Countries. World Bank. Available at http://www.worldbank.org.cn/English/Content/460a6377587.shtml	Explains how FDI and remittances have surpassed private lending as a source of financing in developing countries.
Social Considerations in FDI	
Dean, Judith, Mary Lovely, and Huan Wang. 2003. Foreign Direct Investment and Pollution Havens: Evaluating the Evidence from China. Available at http://www.econ.yale.edu/seminars/NEUDC03/dean.pdf	Explores the debate on whether pollution-intensive industries seek countries with lax environmental standards.
International Labor Office (ILO). 2002. Guide to the Tripartite Declaration of Principles on Multinational Corporations and Social Policy: Knowing and Using Universal Guidelines for Social Responsibility. Geneva: Multinational Enterprises Program, ILO. Available at http://www.ilo.org/public/english/employment/multi/download/guide.pdf	Explains how to create harmony between governments, workers, and foreign firms on social issues related to commercial operations.

Resource and Availability	Description
ILO. Confronting the Social and Labor Challenges of Privatization: Multinational Enterprises in Telecommunications in 1990s. Working Paper No. 90. Geneva: Multinational Enterprises, ILO. http://www.ilo.org/public/english/employment/multi/download/wp90.pdf	Explores the experience of Argentina with the activities of multinational corporations in labor relations in the context of privatization.
Moran, Theodore H. 2002. *Beyond Sweatshops: Foreign Direct Investment and Globalization in Developing Countries.* Washington DC: Brookings Institution. Can be purchased at http://www.brookings.edu/press/books/beyond_sweatshops.htm	Analyzes the labor practices of multinational corporations and evaluates the need for an international agreement to enforce labor standards.
Slaughter, Mathew. 2002. Skill Upgrading in Developing Countries: Has Inward Foreign Direct Investment Played a Role? Working Paper no. 192. OECD Development Centre. Available at http://www.oecd.org/dataoecd/8/20/1949135.pdf	Examines the interaction between a host county's policies regarding multinational corporations, its educational system, and the training and education activities of multinational corporations.
Tanzi, Vito and Hamid Davoodi. 2003. Road to Nowhere: How Corruption in Public Investment Hurts Growth. *Economic Issues* No. 12, Washington DC: IMF. Available at http://www.imf.org/external/pubs/ft/issues12/issue12.pdf	Explores the effect of corruption on economic growth and development.
United Nations Environment Programme. 2000. *Environment and Trade: A Handbook.* Canada: International Institute for Sustainable Development. Available at http://www.unep.ch/etu/etp/acts/aware/handbook.pdf	Describes the relationship between trade and the environment and discusses investment.
Willem te Velde, Dirk. 2002. Government Policies for Inward Foreign Direct Investment in Developing Countries: Implications for Human Capital Formation and Income Inequality. Working Paper no. 193. OECD Development Centre. Available at http://www.oecd.org/dataoecd/8/23/1949219.pdf	Examines the effects of government policies on the relationship of human capital formation to income inequality.

APPENDIX C
Glossary

Absorptive capacity. Ability of a country or region to assimilate and put foreign investment to productive use and to benefit from *FDI spillovers.*

Adaptive strategies. Foreign investors' marketing tactics, production plans, and methods that have been altered to suit local conditions in foreign markets.

Adjustment cost. Economic and social expense of reallocating resources from domestic industries that were forced to contract as a result of international competition, such as from foreign investors.

Administrative barriers. Complex and cumbersome government procedures that investors must follow before or after setting up a commercial enterprise. Also known as "red tape."

Affiliate. An enterprise in which a foreign investor has an effective voice in management. May be a subsidiary, associate, or branch.

Balance of payments. A summary of the flow of trade and capital in and out of a country. Foreign direct investment is recorded in the balance of payments under the "capital account."

Bilateral investment treaty (BIT). An agreement between two countries providing for nondiscriminatory treatment of FDI and containing provisions for prompt resolution of disputes arising between governments and foreign-owned enterprises.

Business linkages. Supplier–producer and other relationships between an affiliate of a foreign-owned enterprise and a domestic firm. Links between foreign enterprises and small and medium domestic enterprises are an important medium for job creation, technology transfer, and increases in FDI's spillover effects.

Contagion, financial. Spread of macroeconomic difficulties from one country to another, usually reflected in unstable and rapid movements in exchange rates and stock market prices. Can be a cause or consequence of foreign investor panic, particularly with respect to *portfolio investment.*

Corporate code of conduct. Policies that define and establish a corporation's ethical standards for doing business at home and in other countries.

Corporate social responsibility. A corporation's social obligations expressed through philanthropic activities and commitment to societal and environmental goals that go beyond maximizing profit.

Corporate tax rate. Domestic tax on the income of corporations. Affiliates of foreign-owned enterprises are highly interested in the Effective Tax Rate, which is the percentage of total income paid to all forms of taxes.

Cross-border merger or acquisition. A company based in one country buying, absorbing, or legally partnering its assets and liabilities with a company based in another country.

Cross-border production network. A manufacturing chain that has its various stages located in different countries (e.g., Mexican manufacturers supply parts to U.S. companies). Transportation efficiency, customs and border delays, bilateral and regional trade agreements, and the general investment climate influence the formation and operation and/or profitability of these networks.

Cross-licensing. Arrangement by which a firm allows another firm to exploit proprietary rights in its patents, trademark, or trade secrets in exchange for the intellectual property rights of the second firm.

Debt securities. Financial instruments representing borrowed capital that must be repaid and having a fixed amount, specified maturity, and usually a specified interest rate (e.g., bonds, treasury bills, commercial paper).

Direct investment enterprise. An incorporated enterprise in which a foreign investor owns 10 percent or more of the equity or an unincorporated enterprise in which a foreign investor has equivalent ownership. Also referred to as *foreign-invested enterprise (FIE).*

Dividend. The portion of the direct investment enterprise's profit paid to shareholders and not reinvested in the business.

"Doing Business" Project. A World Bank initiative that measures the "red tape" embodied in administrative costs and delays in starting a business, hiring and firing workers, seeking credit, enforcing contracts, and closing a business in 145 countries. The coverage will be expanded in 2005 and beyond to encompass more countries and more indicators. Annual updates allow cross-time comparisons that should reveal the impact of regulatory and administrative reforms.

Domestic content. The percentage of a foreign-owned firm's manufactured product that is sourced locally (i.e., in the host country).

Domestic private investment. Capital outlay by local companies and entrepreneurs for productive purposes.

Dutch disease. A rise in the real exchange rate due to rapid and large inflows of foreign exchange (often through loans from donor organizations but also possibly through foreign investment) into a country, which renders the exports of the recipient economy uncompetitive in world markets.

Efficiency-seeking foreign direct investment. Capital expenditure that pursues reductions in input costs and maximization of profits, such as by moving manufacturing operations from a home country to a host country with less expensive labor.

Embed. When the commercial activity of foreign enterprises forms part of the economic life of a country or community (i.e., through use of local inputs and labor).

Enclave. An artificial area or territory within a country where economic activity is concentrated and with little benefit for or *spillover* effect on the wider economy (e.g., certain export processing zones).

Equity capital. Investment made to acquire interest in a commercial enterprise.

Export platform. Industrial strategy in which a country identifies particular geographic areas or policy schemes to promote itself as a base for manufactured exports. These schemes include bonded warehouses, export processing zones, and duty exemption or drawback systems. Export-platform FDI occurs when most of the enterprises' output is sold in a third market rather than the host country.

Export processing zone (EPZ). Area within a country with its own customs clearance procedures and financial incentives for attracting export-related investment. These may be geographic areas isolated from the surrounding economy that provide duty exemptions on imported inputs, as well as tax incentives to investors. Or they may be "serviced sites" that provide superior infrastructure, such as information and communications technology, to lure investors. Some countries designate specific factories as export processing zones.

Expropriation. Forcible acquisition of private property by a government agency for a purpose deemed to be in the public interest even if the owner of the property is not willing to sell.

Extractive industry. Principally the oil, gas, and mining industries. Important attractor for *natural resource-seeking FDI* in sub-Saharan Africa and other regions.

Feeder industries. Commercial enterprises that supply goods and services to larger companies.

Flow, FDI. Amount and direction of FDI capital, inward or outward, over a given time period.

Footloose. Describes the practice of foreign investors of moving from one country to another in search of less regulation or more profits.

Foreign Corrupt Practices Act (FCPA). An act of the U.S. Congress making it unlawful for U.S. companies to bribe foreign government officials to obtain or retain business.

Foreign direct investment (FDI). Capital expenditure by an entity resident in one country (direct investor) for an enterprise resident in another country *(foreign direct investment enterprise)* with the objective of establishing a lasting interest (usually of at least 10 percent).

Foreign-invested enterprise (FIE). An incorporated enterprise in which a foreign investor owns 10 percent or more of the equity or an unincorporated enterprise in which a foreign investor has equivalent ownership. Also referred to as *direct investment enterprise.*

Foreign portfolio investment (FPI). Capital expenditure by a resident entity in one country (direct investor) for an enterprise resident in another country *(direct investment enterprise)* without the objective of establishing a lasting interest, such as in stocks, bonds, and other securities.

Global production chains. Network of economic activity managed to produce a product or service. Sometimes referred to as supply chains or *cross-border production chains.*

Greenfield investment. A foreign investor's capital outlay to acquire new assets such as buildings and land. Usually differentiated from *mergers and acquisition* where existing physical assets are purchased.

Home country. Country of incorporation of a foreign investor.

Host country. Country receiving foreign investment.

Incentive. Fiscal measure such as tax relief or loosening of regulatory controls, intended to encourage private capital expenditure. See *race-to-the bottom.*

Investment climate. Sum of characteristics that determine the viability of establishing and operating a business in a particular country and hence the country's attractiveness to investors. Measured by indicators and processes such as the World Economic Forum's Global Competitiveness Report, the World Bank's Investment Climate Assessment, and the World Bank's Doing Business surveys.

Investment dispute settlement. Confidential process for hearing and resolving disputes between governments and foreign investors. The International Centre for Settlement of Investment Disputes (ICSID) and others provide settlement mechanisms.

Investment guarantee. Risk management tool for allaying investors' fears of investing in politically uncertain environments. *See political risk.*

Investment promotion agency (IPA). Government or quasi-government organization set up to increase a country's inward investment through image-building, promotion, investor services, and improving the investment climate.

Investment promotion intermediary (IPI). Any of the various public, private, and civic organizations involved in investment promotion (e.g., investment promotion agencies, export processing zones, chambers of commerce, commercial attaches).

Investor roadmap. A USAID tool for identifying policy and administrative barriers to investing and operating a business in developing countries by four stages: entry, establishment, location, and operation.

"**Ladder Effect.**" Moving up the production *value chain* of the same or new products through additional use of technology or human capital as input. Reflects dynamic *location advantage.*

Liberalization, investment. National or regional policy that aims to reduce regulatory controls and legal restrictions on the movement of investment capital.

Liquidity. The ability, access, and flexibility of converting economic assets into cash.

Location advantage. Similar to comparative advantage but incorporates the entire package of favorable policy, incentives, strategic opportunity, and other tangible and non-tangible benefits making a country or region attractive to foreign investors.

Majority-owned foreign affiliate (MOFA). Branch of a multinational corporation in which the parent company's equity stake exceeds 50 percent.

Market-seeking FDI. Investment undertaken to produce for and serve a domestic or regional market, to access a large consumer market (i.e., China), or sometimes to circumvent barriers to serving the target market through exporting from the home country.

Multilateral Agreement on Investment (MAI). Accord proposed at the OECD to provide binding rules governing foreign investment. International negotiations were suspended in the late 1990s.

Multi-Fibre Arrangement (MFA). A quota system for the textiles and apparel industry that for many decades permitted developed countries (predominantly the United States and the European Union) to restrain imports of covered products from low-cost production sites abroad. As a result of these quotas on the world's most competitive, large-scale producers, less competitive producers in other low-cost sites (primarily poorer developing countries) were able to attract foreign direct investment to the apparel sector. Elimination of the MFA quotas was agreed in 1995 under the World Trade Organization Agreement on Textiles and Clothing, and progressively phased in over a ten-year period. Quotas were abolished in January 2005. Many developing countries that had developed significant apparel industries as a result of quota-skirting foreign direct investment are worried about disinvestment in the post-quota world.

Multilateral Investment Guarantee Agency (MIGA). An arm of the World Bank facilitating foreign investment in developing countries by providing *political risk* insurance for investors and investment promotion capacity building for member countries.

Multinational corporation, multinational enterprise (MNC or MNE). A company with productive operations in many different countries, as distinguished from international companies that operate in one country and export to others.

National treatment. The handling of foreign goods, services, or investment no less favorably than competing local goods, services, or investment.

Natural-resource-seeking FDI. Capital investment for the exploration or exploitation of raw materials such as petroleum, precious minerals, and forestry products.

Organization for Economic Co-operation and Development (OECD). Paris-based organization comprised of 30 member countries (primarily developed) committed to democratic government and the market economy. The OECD is best known for its publications and statistics. It produces and disseminates information and statistics on globalization, corporate governance, investment promotion, sustainable development, and other global economic issues.

Offshoring. The practice of relocating a production activity, task, or process to a foreign country to cut production costs (e.g., a French car manufacture relocates its auto parts production to Croatia). The enterprise usually maintains ownership of foreign facilities.

Outsourcing. The practice of moving an internal production activity, task, or process to a location other than the home base of an organization but usually in the same country. Outsourced activities and related facilities are not normally part of an enterprise's core activities (e.g., human resources functions of a car manufacturer). The enterprise does not "own" the foreign facilities doing outsourced work.

Overseas Private Investment Corporation (OPIC). Organization created by an act of the U.S. Congress that provides loans, guarantees, and insurance for doing business in emerging markets.

Parent company. A multinational corporation's home country-based firm.

Performance requirements. Government rules stipulating that foreign investors must meet particular national objectives, such as a directive that a certain amount of production be for exports.

Political risk. Possibility that a political event, such as war, or noncommercial development, such as economic nationalism, will result in expropriation or will restrict repatriation of FDI earnings.

Privatization. Partial or total sale of state-owned enterprises and commercial interests to private investors.

Profit repatriation. Flow of FDI earnings back to the parent company's home country.

Production efficiency. Cost savings realized by enterprises through discovery or by instituting new processes or technology in the production system.

Public investment. Expenditure by government on public goods or government-owned companies.

"Race to the bottom." Relaxation of environmental and labor standards by countries to gain a competitive edge in attracting FDI.

Regulatory framework for investment. The entire legal and regulatory system governing the entry, operation, and exit strategies of investors within a country or region. A relatively well-designed, transparent, and stable regulatory framework is important for all investment, particularly foreign investment.

Reinvested earnings. Portion of profit of foreign subsidiaries and associated enterprises (the direct investment enterprise) not distributed as dividends or remitted to the investor's home country.

Resident investment adviser. Foreign expert who works full time in a developing country's *investment promotion intermediary* to advise on the country's investment promotion agenda.

"Round tripping." Domestic investment disguised as foreign investment to qualify for tax and other incentives available only to foreign investors. Investment capital can also flow "out" to take advantage of higher returns overseas and then flow "in" as foreign investment. Can result in double counting of FDI inflow. Often refers to Chinese investment in Hong Kong that is reinvested into China to take advantage of preferential treatment accorded foreign investment.

Services sector. Sector that produces a broad range of non-tangible products and is increasingly the largest in most economies; includes banking and finance, transportation, retail, tourism, travel, construction and health, among others.

Singapore issues. Four issues on the WTO agenda: investment, competition policy, trade facilitation, and transparency in government procurement. At the WTO Ministerial meeting in Singapore (1996), ministers agreed to create working groups to explore a multilateral framework for each issue. At the Cancun WTO Ministerial in September 2003, countries failed to reach consensus on future negotiations on any of these issues. In the summer of 2004, WTO members did agree to establish a negotiating group on trade facilitation, but consensus on the remaining three Singapore issues has remained elusive.

South-South FDI. Inward FDI into a developing country from another developing country. Chinese and South African companies are increasingly active investors in Asia and Africa, respectively.

Spillover effect. Transfer or absorption of technology, expertise, or productivity improvements by host-country firms or sectors through interaction with direct investment enterprises.

Stock, FDI. Total value of foreign-owned assets in a country at a given point in time.

Subsidiary. An incorporated enterprise in a host country in which another entity directly owns more than half of the shareholders' voting power, or is a shareholder in the enterprise, and has the right to appoint or remove a majority of the members of the administrative, managerial, or supervisory body.

Subnational investment promotion. Activities that encourage investment in economically depressed or government-prioritized regions and that frequently involve the use of investor incentives.

Trade and Investment Framework Agreement (TIFA). Mechanism used by the United States to structure bilateral consultations with another government relating to trade and investment. Consultations encompass broad range of issues, including services, investment, trade in goods, and intellectual property protection. A TIFA is generally a pre-requisite for talks leading to a bilateral investment treaty (BIT) or free trade agreement (FTA).

Trade-related investment measure (TRIM). An investment-related measure that restricts or distorts trade, such as a requirement that investors use local inputs in production, or that they meet export performance mandates.

Transfer pricing. The price of goods exchanged or sold between affiliates of a multinational corporation. Because of the absence of a market price, these prices can be manipulated.

United Nations Conference on Trade and Development (UNCTAD). The focal point within the United Nations system for the integrated treatment of trade and development and related issues in investment, finance, technology, enterprise development, and sustainable development. UNCTAD was established in 1964. It functions as a forum for intergovernmental deliberations, undertakes research, policy analysis and data collection, and provides technical assistance.

Value chain. A subset of a *(global) production network* and the full range of activities involved in making a product or providing a service, from conception to disposal. Adding "value" to a production chain improves the product or service and requires the use of new forms of knowledge or capital, or both.

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