USAID
FROM THE AMERICAN PEOPLE

FOREIGN DIRECT INVESTMENT

PUTTING IT TO WORK IN DEVELOPING COUNTRIES

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The primary author of this resource guide is Roger Manring of Nathan Associates.

For further information or for hard copies of publications, please contact

Erin Endean
Nathan Associates Inc.
Project Manager, Trade Capacity Building Bridge Task Order
eendean@nathaninc.com

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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 2005, $238 billion in FDI, on a net basis, flowed to developing countries—roughly one-half of net resource flows. FDI is therefore the single largest external source of resource flows to developing economies, including other private sources, such as portfolio equity and debt, and official sources, such as loans and grants. FDI consists of investment in wholly new facilities, also known as greenfield investment, or the purchase of existing facilities, also known as mergers and acquisitions. Greenfield investments are the most common type of FDI in the developing world.

Though FDI is now the most important and most stable external source of funding 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 since 1990, and has fallen to 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

- Improving export capacity and increasing imports of foreign-invested firms—both of which help local firms integrate into global production networks.
- Stimulating technology transfer in production and management processes.
- Advancing training and skill development among workers.

- Strengthening 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. Focused largely on extractive industries—petroleum and minerals—the attainment of natural resources may also motivate investors in forest resources, plantation agricultural production, and large-scale fisheries. Much of this investment is solely for the extraction and export of primary commodities in bulk form, although important follow-on investments in processing, packaging, and transport of products also exist.

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 1980s. 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 forms 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-third of global FDI inflows in 2005, the most recent year for which information is available. Those inflows, however, are highly concentrated among a few countries. In 2005, 60 percent of inflows to the developing world went to only 10 countries. China received the largest amount of FDI—$72 billion, dwarfing the inflows to the next three top recipients, Mexico, Brazil and Russia, whose individual receipts ranged from $15 billion to $18 billion each.

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 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 in the near future; India is also expected to present new opportunities as it liberalizes services.

Services that are tradable, including those made tradable thanks to information technology, consist of business support activities such as accounting, recordkeeping, and R&D. Providers 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 FDI in services will likely surge, far outpacing the dramatic increases of the 1980s and 1990s in manufacturing. 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 and productivity, 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 is mixed at the industry level, 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.

Four 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; the renewal of interest of foreign investors in opportunities for the private financing of public infrastructure; 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 national and subnational 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 country's investment climate. A sound climate not only attracts FDI, but also 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, technological, and social infrastructure, such as power, water, transport, and communications systems; information and communications technology; and health and education services.

Once a government begins achieving macroeconomic stability, it tends 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 subclimate 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.

Tools, such as the World Bank's Doing Business survey and the OECD's new Policy Framework for Investment, are used in assessing investment climates and mapping improvement programs. Just as important as the content of investment climate reform is the process of reform, starting with trade and product market reform, building informed pro-reform constituencies, creating implementation incentives and oversight mechanisms, and so on.

Although a sound investment climate is nearly always a prerequisite for attracting FDI, most countries also market themselves as efficient and business-friendly investment destinations. In the past 20 years, IPAs have become central to the effort of developing countries (and many developed ones) to attract FDI. IPAs generate FDI prospects by targeting markets and investors, 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.

INTERNATIONAL AGREEMENTS AND INSTITUTIONS FOR FDI

Cooperative action at the international level has reinforced countries' unilateral efforts to liberalize their investment climates. A number of bilateral and regional agreements on investment have been put in place for this purpose. About 2,500 bilateral investment treaties have been concluded worldwide, despite questions about their usefulness, and many bilateral or regional trade agreements have investment provisions. Certain WTO rules, such as the Agreement on Trade-Related Investment Measures, also influence FDI. In the future, developing economies may very well prefer regional pacts as the path to international agreements on investment.

Several international and regional institutions facilitate and support FDI flows. The World Bank's Multilateral Investment Guarantee Agency and the World Association of Investment Promotion Agencies, for example, provide training and technical assistance related to implementing multilateral investment agreements and strengthening FDI promotion skills and institutions. Other institutions provide risk mitigation instruments and related services and information. These include such bilateral organizations as the U.S. Overseas Private Investment Corporation 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 programs or projects to support FDI in developing countries.

Within those parameters, USAID should assist only countries that have clearly demonstrated 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 predetermined 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, such as those in sub-Saharan Africa or those that have lost 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 more reliable and cost-effective 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 that 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 770,000 foreign affiliates of at least 77,000 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 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 to drive development. For this reason, the Guide's special concern is the relevance of FDI's past trends and future directions, benefits, and institutional arrangements to the developing world.

The Guide is organized to be a ready resource on various aspects of FDI. This chapter sets forth basic definitions of FDI and its elements. Chapter 2 explores FDI's development advantages, including its ability to spur productivity, beginning with an examination of investors' motives. Chapter 3 presents trends in FDI flows since 1990, and examines recent flow patterns by region, country concentration, and country income. Drawing on this information, Chapter 4 offers insights on the likely future of FDI, including 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, 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's impacts in developing countries.

The appendixes provide reference material. Appendix A presents 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 within this debate, most 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 equally of net private flows and net official flows (loans and grants). By 2005, net flows had more than quadrupled to $472 billion, but share distribution had shifted radically: private capital ($491 billion) accounted for *all* external flows to the developing world, while official capital had actually turned negative ($-19 billion) as developing country payments to official creditors outstripped bilateral aid grants received (Table 1-1).

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, and 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 a peak of more than $29 billion by 2002. As a result, Ireland's total inward stock of FDI reached $211 billion in 2005, 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.

Net external private capital flows consist of FDI, portfolio equity, and private commercial debt.[3] Between 1990 and 2005, all three grew significantly in absolute terms. In 1990, net external private capital flows to the developing world totaled about $55 billion, made up of FDI ($24 billion, or 43 percent), portfolio equity ($3 billion, or 5 percent), and private debt, both long- and short-term loans (more than $28 billion, or 51 percent). In 2005, according to World Bank statistics, FDI had increased tenfold to $238 billion, or nearly half of all net private external capital, and continued to represent the largest single flow. Portfolio equity had risen even more sharply to $61 billion (13 percent of total), while private debt increased to $192 billion (39 percent). The growth paths of these three flows,

Table 1-1

Net Total Resource Flows to Developing Countries, by Source, 1970, 1980, and 1990–2005 (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	260.2	199.2	172.4	6.9	19.9	61.0	34.3	26.7
1999	240.8	198.4	183.3	12.6	2.5	42.4	13.9	28.5
2000	210.6	187.6	168.8	14.1	4.7	23.0	-5.7	28.7
2001	209.7	154.4	176.9	6.4	-28.9	55.3	27.4	27.9
2002	209.3	171.6	160.3	5.8	5.5	37.7	5.2	32.5
2003	303.3	271.9	161.6	25.2	85.1	31.4	-12.3	43.7
2004	418.2	396.6	211.5	37.3	147.8	21.6	--28.7	50.3
2005[c]	471.7	490.5	237.5	61.4	191.6	-18.8	-71.4	52.6

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

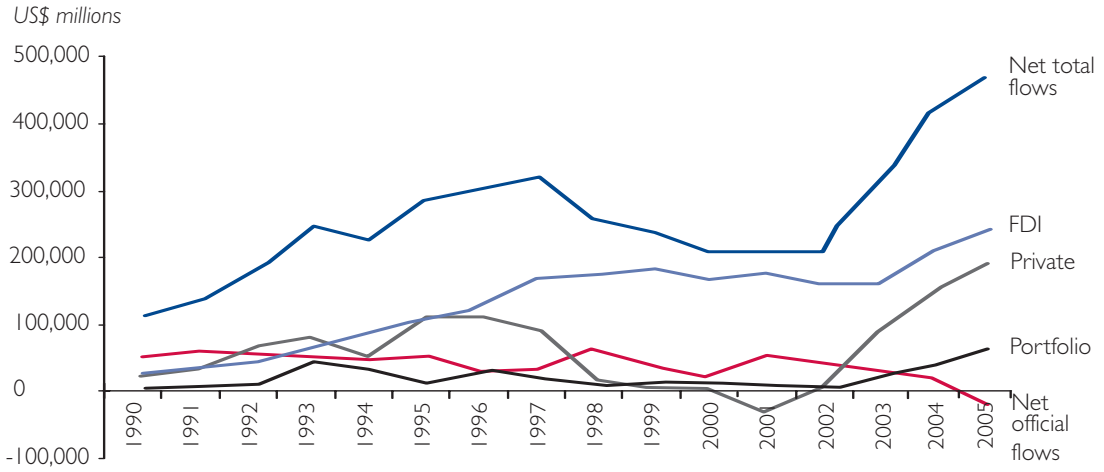
SOURCES: 1998-2004 data from World Bank, *Global Development Finance 2006*. Data for all prior years from Global Development Finance Database, 2004.

however, have been dramatically different. All rose and fell in value during the 1990–2005 period, but peaks and valleys for FDI have been much less volatile than for those for portfolio equity or debt. Hence, FDI has emerged as the developing world's largest and most durable source of external capital, especially over the last 10 years, through the Asian Financial Crisis of the late 1990s and the global economic slowdown in the first years of the new millennium. (Figure 1-1).[4]

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 $2.3 trillion in 2005. Gross FDI inflows were only about $285 billion, or just over 12 percent of that amount. Domestic sources of capital, private and public, thus supplied more than $2 trillion or about 88 percent of developing countries' annual investment in 2005. Though FDI's share in gross fixed capital formation rose as high as 15 percent at one point (1999), it has never exceeded that share, and has fallen to as low as 3–4 percent

Figure 1-1
Net Total Resource Flows to Developing Countries by Type, 1990–2005



SOURCE: World Bank, Global Development Finance Database, 2004 (1990-1997 data); *Global Development Finance 2006* (1998-2005 data).

(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.

The value of FDI to the developing world runs well beyond the investable funds it channels into capital accumulation. FDI can be uniquely powerful in 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 to the rapid and efficient transfer and 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 nonequity 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, access to export markets—all in one package. But what, precisely, constitutes foreign direct investment?

FOREIGN DIRECT INVESTMENT DEFINED

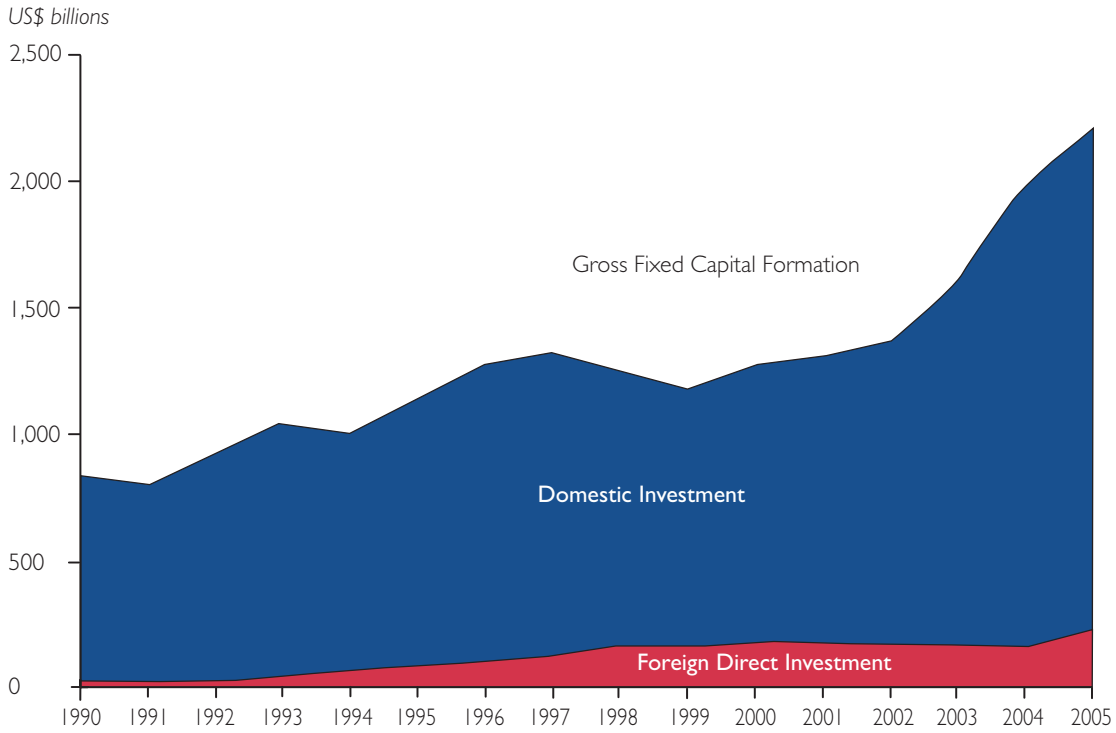
For purposes of statistical and policy analysis, the official definitions of FDI are provided by the International Monetary Fund (IMF) and the Organization for Economic Co-operation and Development (OECD).[5]

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

Figure 1-2

Total Domestic Investment and Foreign Direct Investment in Developing Countries, Annually, 1990–2005



Note: Includes data only on economies classified as low or middle income by the World Bank (2005 per capita GNI of $10,725 or less).

SOURCES: UNCTAD, *World Investment Report 2006* for FDI inflows data; World Bank, *World Development Report 2007* for country classifications.

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. 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.[6]

A parent enterprise may undertake an FDI transaction in a foreign 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 it may desire special synergies for home country assets possible only through partnership with a foreign affiliate. Rationales for FDI are further addressed in Chapter 2.

M&A AND GREENFIELD FDI

The foreign affiliate established by FDI can be a greenfield investment or a cross-border merger and acquisition (M&A). Greenfield FDI is capital movement by the parent enterprise to create new production facilities in a foreign location (e.g., plant and equipment in manufacturing, or intangible capital for services production). The M&A is a capital movement enabling the parent

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 center. Attracting FDI has been one key to its success—annual FDI inflows were about $90 million in 1970, but are $20.1 billion today. By harnessing the technological and business power of multinational enterprise associated with these flows, Singapore moved rapidly 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 the impacts of FDI, Singapore has adopted a carefully managed industrial policy that rests on five prerequisites: (1) an open economy that imposes market discipline; (2) excellent infrastructure and a predictable, business-friendly investment climate; (3) an open labor market; (4) a high-quality professional civil service; and (5) meritocratic, results-oriented government, able to rapidly recover from and correct its mistakes. See Asian Development Bank, *Asian Development Outlook 2004, Part 3 Foreign Direct Investment in Developing Asia*, pp. 230–231.

enterprise to merge with or acquire an existing company in a foreign location. Over the years 2003–2005, cross-border M&A accounted for about two-thirds of the world's FDI flows (Table 1-2). The remaining third consisted of greenfield FDI as well as other follow-up FDI flows, such as reinvested earnings and intracompany loans (see below).[7] This global average hides considerable year-to-year variability in cross-border M&A. It also masks a striking difference in the relative portions of M&A versus greenfield and other flows in the developing and developed worlds. M&As consistently make up by far the greatest share of FDI flows in developed countries as a group, but greenfield FDI dominates in developing countries (Figure 1-3).

Initially at least, the two types of FDI may have distinct impacts in host economies: greenfield investments add immediately to capital stock and employment, while cross-border M&A brings ownership change but not necessarily near-term expansion in productive capacity. UNCTAD research suggests, however, that their relative effects differ little over time.[8] Both tend to generate follow-on investments, as well as potential technology and knowledge transfers for the host economies.

One new trend in cross-border M&A activity is the involvement of private equity funds based in the United States and the United Kingdom, as well as Hong Kong and the Middle East.[9] Compared to multinational corporations, the traditional sources of FDI, private equity funds have shorter time horizons for their investments (e.g., five to six years), and are more concerned with generating near-term returns for shareholders than with developing global production or distribution networks. Consequently, their impact on the nature and growth of cross-border M&A transactions in developing countries and FDI in general, while still uncertain, may be different than that of multinational corporations.

Table 1-2

FDI byType: Merger & Acquisition vs. Greenfield and other, Developed and Developing World, 2003-2005

	Total FDI		M&A		Greenfield and Other[a]	
	Million $	%	Million $	%	Million $	%
World	2,184,901	100.0	1,393,888	63.8	791,013	36.2
Developed countries[b]	1,455,267	100.0	1,186,300	81.5	268,967	18.5
Developing countries	729,634	100.0	207,588	28.5	522,046	71.5

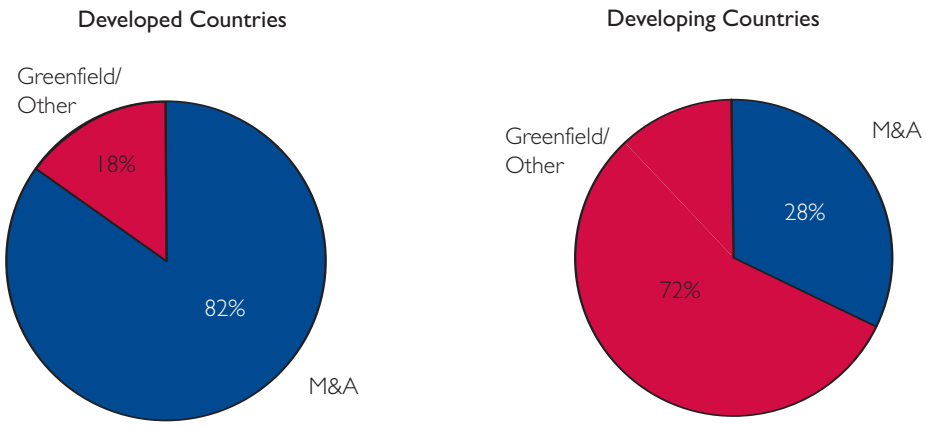
[a] Estimated as a residual after M&A FDI. Includes initial investment in new production facilities plus other post-entry FDI flows, such as reinvested earnings and intracompany loans.

[b] "Developed countries" includes data on economies classified as high income by the World Bank (2005 per capita GNI of $10,726 or more). "Developing countries" includes data on economies classified as low or middle income by the World Bank (2005 per capita GNI of $10,725 or less).

SOURCES: Nathan Associates, based on UNCTAD, *World Investment Report 2006*, Annex Tables B.1 and B.4. World Bank, *World Development Report 2007* for country classifications.

Figure 1-3

FDI Inflows by M&A and Greenfield/Other Components, 2003-2005



Notes: "Developed countries" includes data on economies classified as high income by the World Bank (2005 per capita GNI of $10,726 or more). "Developing countries" includes data on economies classified as low or middle income by the World Bank (2005 per capita GNI of $10,725 or less). Greenfield/other estimated as a residual after M&A FDI. Includes initial investment in new production facilities plus other post-entry FDI flows, such as reinvested earnings and intracompany loans.

SOURCES: Nathan Associates, based on UNCTAD, *World Investment Report 2006*, annex Tables B.1 and B.4. World Bank, *World Development Report 2007* for country classifications.

FDI BY FINANCIAL COMPONENT

A foreign direct investment is established in the initial transaction between the parent enterprise and the foreign affiliate, but subsequent transactions are also FDI flows. While the conventional image of FDI 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 can have three financial 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 affiliate. 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 reinvested retained earnings. 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 1-4). These proportions may differ by region, probably because of the nature of FDI-financed affiliates in each region. For example, in the period in question, equity capital may account for a larger share of Latin America's FDI because of cross-border M&As 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 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

Volatility in Private Capital Flows to the Developing World

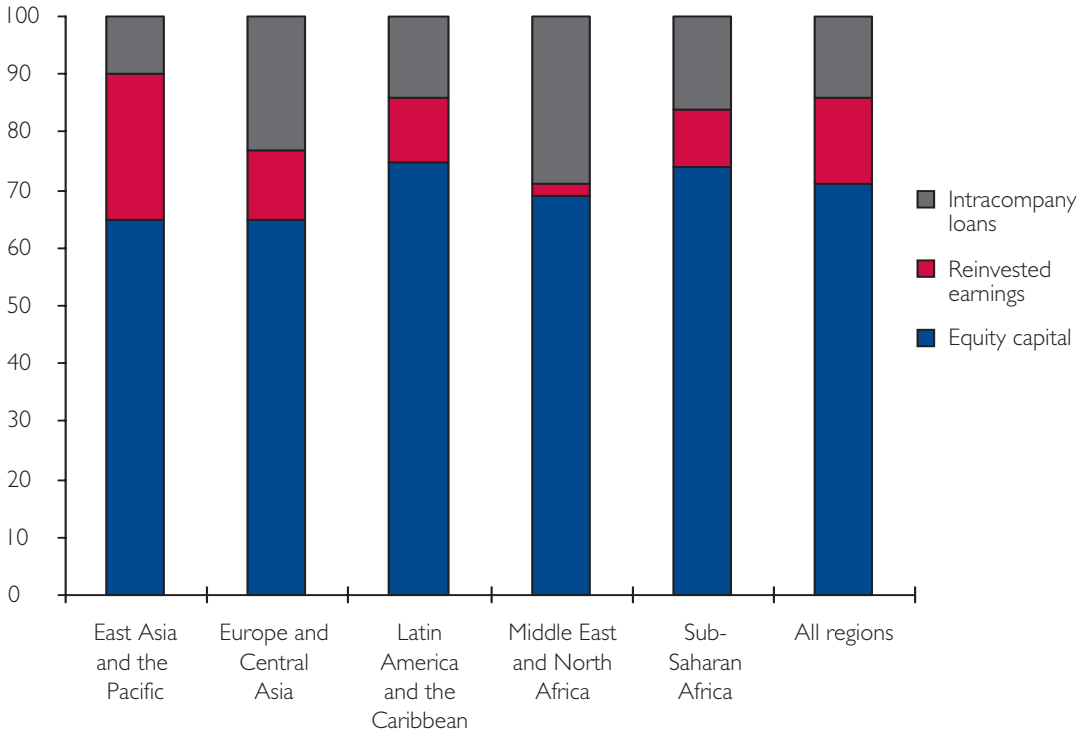
As a source of development capital, the durability of FDI is in stark contrast to the volatility of portfolio equity and debt. Portfolio equity players typically seek financial market investments with a much shorter time horizon, and respond quickly and dramatically to changes in economic circumstances. Likewise, lenders can call in debts 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 $6 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 2001 becoming negative-net outflows of capital from developing countries. More recently, with improving economic conditions globally and in emerging markets, portfolio equity and private debt flows to developing countries have skyrocketed (Table 1-1).

parent companies and their foreign affiliates use them to reduce exposure to risk in response to changing economic conditions.[10] During the Asian Financial Crisis and Brazil's period of economic stress in 2001/2002, 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.[11]

Figure 1-4

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

Percent



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.

2. THE CASE FOR FDI

International business has consistently and dramatically expanded FDI activity because it makes business sense to do so. 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. 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.[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 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, FDI has led to the establishment of facilities for not only producing, but also processing, packaging, and transporting extractive resources and primary agricultural products. FDI's role in developing Chile's salmon industry is one example, though in the food industry in general, large developed-country retailers often organize international value chains through nonequity contracting arrangements rather than by FDI.[2] For large-scale oil and mineral extractive activities, the developed world generates most resource-seeking FDI, but developing country multinationals are increasingly engaged—witness China National Petroleum Corporation's $4 billion deal to acquire PetroKazakhstan, or AngloGold Ltd of South Africa's $1.5 billion purchase of Ghana's Ashanti Goldfields. Indeed, China's rapid economic growth has induced it in recent years to become a significant investor in many natural resources.

Foreign Direct Investment Motives and Host Country Attributes

Investors seeking ***resources*** or ***assets*** prefer host countries with raw materials and primary commodities. Investors seeking ***markets*** prefer locations with

- Markets of a suitable size and per capita income,
- Markets that are growing,
- Access to regional and third-country markets, and
- Proximity to strategic clients and customers.

They also pay close attention to country-specific consumer preferences and the structures of markets (concentration, price structure). Investors seeking ***efficiency*** seek host countries with

- Low-cost unskilled labor,
- Skilled labor,
- Favorable costs for inputs (e.g., transport and communications to/from host country) and intermediate products, and
- Membership in a regional integration agreement conducive to establishment of regional corporate networks.

Investors seeking ***strategic assets*** select locations that have

- Assets based on technology or innovation (e.g., brand names) including assets,
- Assets embodied in individuals, firms, industry clusters (e.g., R&D capabilities), and
- Physical infrastructure (ports, roads, power, telecommunications).

SOURCE: Nathan Associates based on UNCTAD, *WIR 2003*, p. 85.

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). Producing locally, for example, may cut transport costs or avoid the high production costs of the home country, or 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.[3] The entry 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.[4] 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. Recent examples of market-seeking FDI include the $4 billion acquisition of

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. The configuration is not static; it shifts fluidly in response to evolving production costs, changes in the investment climate, 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 World Bank, *Global Economic Prospects and the Developing Countries 2003*, especially Chapter 2, "Changes in Global Business Organization," pp. 45–65.

Braco SA, a Brazilian brewery, by Interbrew SA of Belgium, and the $1.7 billion purchase of BoCOMM, a firm in China's banking sector, by HSBC Holding.

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. Worldwide, trade liberalization has facilitated movement of parts, components, and final products to stimulate this FDI.

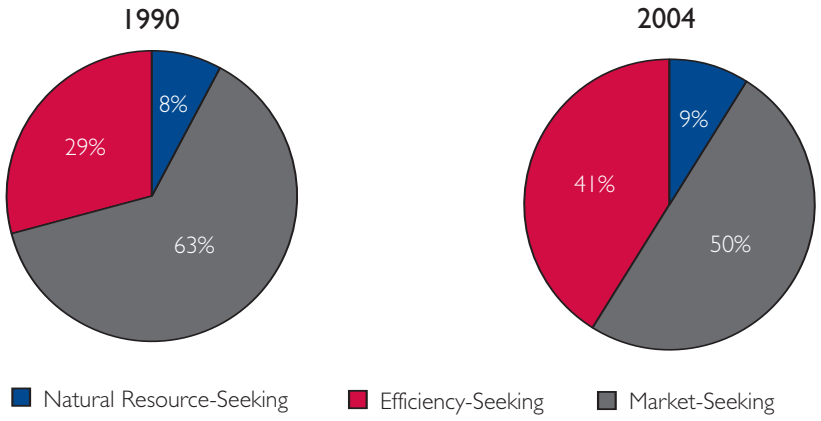
The global production networks that resulted from efficiency-seeking FDI now handle much of the world's manufacture of electronics, information technology, automobiles, and other transport equipment and industrial machinery. Developing countries' low-cost, high-productivity labor has been their point 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 rises, 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.[5]

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. Examples of efficiency-seeking FDI in services include development of offshoring operations for IT services, call centers, and business processing operations to locations as diverse as India, Estonia or the Philippines. 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.[6]

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, patents, specialized management skills and systems, infrastructure, or a brand with market power. Much foreign direct investment in airline privatizations in the 1990s was often 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 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."[7] Undertaken mostly in developed

Figure 2-1
Estimated Distribution of Developing Countries' Inward FDI Stock by Business Purpose, 1990 and 2004



Note: Includes data only on economies classified as low or middle income by the World Bank (2005 per capita GNI of $10,725 or less). Date for 2004 includes countries of South-East Europe and the Commonwealth of Independent States. For the purposes of this estimate, strategic-asset seeking FDI is subsumed within the efficiency-seeking and market-seeking categories.

SOURCES: Inward FDI Stock data from UNCTAD, *World Investment Report 2006*, estimates of distribution by business purpose by Nathan Associates. World Bank, *World Development Report 2007* for country classifications.

countries through mergers and acquisitions, this type of FDI is small but growing in developing countries.

RANKING FDI MOTIVATIONS

Data on FDI inflows are not normally recorded by business purpose. But given certain assumptions about the nature of various industries and their likely attraction for FDI, the relative importance of investor motives can be estimated on the basis of UNCTAD's figures on FDI inward stock by sector and industry.[8] Though rough, these estimates suggest that market-seeking may still be the dominant motive, accounting for nearly half of all FDI inward stock. Efficiency-seeking FDI is probably the next most important, followed by FDI for resource-seeking purposes. This ranking, however, seems to be evolving: between 1990 and 2004, efficiency-seeking FDI appeared to gain significantly in its share of total developing country FDI stock, while marketing-seeking FDI lost a like amount (Figure 2-1). Resource-seeking FDI probably amounts to about 8 percent of the total accumulated stock of FDI in the developing world. With sustained global economic expansion—and especially rapid growth in China and India—generating increased demand for energy and raw materials, the resource-seeking share in total FDI could rise somewhat.

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 2001 through 2005, FDI accounted for just 12 percent of all investment in developing countries and less than 3 percent of their combined GDP (Table 2-1). While these ratios vary by region—in Africa, Europe and Central Asia, and Latin America FDI has been a relatively larger factor in total investment—it is clear that FDI can only be regarded as supplement to domestic investment.

Nevertheless, for developing countries, the reasons for hosting FDI remain compelling: FDI

Table 2-1

Total Gross Fixed Capital Formation and FDI Relative to Gross Domestic Product, All Developing Countries, 2001-2005 (US$ million)

		GFCF		FDI			Domestic Investment		
Region	GDP	Total	% GDP	Total	%GDP	%GFCF	Total	%GDP	%GFCF
Developing countries	37,022,204	8,976,289	24.2	1,034,754	2.8	11.5	7,941,535	21.5	88.5
East Asia and Pacific	10,819,705	3,797,367	35.1	332,736	3.1	8.8	3,464,631	32.0	91.2
Europe and Central Asia	7,525,011	1,517,429	20.2	254,688	3.4	16.8	1,262,804	16.8	83.2
Latin America and Caribbean	9,929,964	1,846,781	18.6	294,476	3.0	15.9	1,552,305	15.6	84.1
Middle East and North Africa	2,601,941	569,365	21.9	44,383	1.7	7.8	524,982	20.2	92.2
South Asia	3,913,563	879,313	22.5	36,193	0.9	4.1	843,120	21.5	95.9
Sub-Saharan Africa	2,232,020	365,971	16.4	72,278	3.2	19.7	293,693	13.2	80.3

Note: Includes data only on economies classified as low or middle income by the World Bank (2005) per capita GNI of $10.725 or less). Data from 2004 includes countries of South-East Europe and the Commonwealth of Independent States.

SOURCES: FDI inflows, GFCF and GDP data from UNCTAD, *World Investment Report 2006*. World Bank, *World Development Report 2007* for country classifications.

contributes directly to economic growth while also appearing to reinforce and accelerate economic development in ways that can transform an economy more quickly or dramatically than domestic investment alone.

ECONOMIC GROWTH

Developing countries see FDI as a growth-inducing flow of financial resources. In this version of the traditional investment–growth paradigm, the effect of FDI in the host economy is little different than that 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.

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.[9] By stimulating complementary activity FDI projects may actually "crowd in" rather than "crowd out" domestic investment, as some have feared.[10] Recent World Bank research emphasizes this finding: controlling for trade openness and level of financial development, analysts conclude that private capital flows—of which FDI now on average accounts for 57 percent —have "a positive and significant impact on (domestic) investment."[11] But these effects depend heavily on

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 for 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.

conditions and policies in host countries. Competitive, open markets favor FDI's boost to investment.

Empirical evidence of a positive relationship between FDI and economic growth in developing countries, if not universally accepted, is also substantial.[12] In export-oriented economies or economies with a relatively well-trained workforce, for example, and well-developed financial markets, 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.[13] 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, but where markets and policies are restricted, FDI's positive effects on growth may blunted.[14]

LINKAGES BETWEEN FDI AND TRADE

One key to the role of FDI in economic growth is the link between FDI and trade. In today's globalized economy, FDI and trade are most often complementary activities, and countries with high inflows of FDI tend to be more open to trade. This complementarity reflects the spread of the "global factory" and efficiency-seeking FDI. It represents a shift from earlier views of exports and (tariff-hopping) FDI as largely substitutes for each other, and is supported by empirical analyses at country, industry, and product levels.[15] Research by UNCTAD suggests that FDI can be a "real and positive factor" in export performance. In a mid-1990s sample of developing countries, for example, a 1 percent increase in FDI per capita was associated with increases in value of 0.45 percent for total manufactured exports, and 0.78 percent for high-technology exports.[16]

Correlation does not necessarily establish causality, but the pattern seems clear. In the developing world, trade and FDI flows have increased rapidly in real terms, annually by about 6 percent and nearly 10.5 percent, respectively, between 1978 and 2001.[17] The operations of

FDI and Network Trade in Transition Economies and Africa

FDI has played a part in expanding network (intraindustry) trade worldwide, but experience in transition economies in Eastern Europe and the former Soviet Union is illuminating. According to recent analyses, FDI in these countries has been the driver of network trade, and differences in levels of FDI appear to explain success in network export performance—especially for Hungary or the Czech Republic in IT components and auto parts. Evidence from this region also demonstrates that even in less capital-intensive industries (e.g., apparel production in Romania), FDI has been important to link firms into global network trade. Recent research from Africa leads to the same conclusion: network trade opportunities will be essential to future development, and Chinese and Indian FDI-financed firms seem to be facilitating the integration of African host economies into global trade. On average, these Chinese and Indian firms are significantly more export-intensive than host country counterparts, and are more diversified and operate higher up the exporting value chains.

SOURCES: Harry G. Broadman, ed., *From Disintegration to Reintegration, Eastern Europe and the Former Soviet Union in International Trade*, Washington DC: World Bank (2006), pp. 339–358; and Harry G. Broadman, *Africa's Silk Road, China and India's New Economic Frontier* (Advance Edition), Washington, DC: World Bank (2006).

multinational corporations have been central to this growth. Multinationals—by definition the source of FDI— are now involved in an estimated two-thirds of all world trade, both intrafirm and with third parties. With their global perspective, these companies make foreign investments that create trade capacity and open new channels to global markets for host economies. The trade flows that result improve resource allocation and create incentives for further FDI. Trade and FDI thus reinforce each other, and together boost productivity among firms in developing countries, enabling them to participate in global production networks and the world trading system.[18]

The interaction between FDI and trade is particularly evident in the dynamics of network trade, notably in parts and components moving through a vertically integrated production structure. Network trade includes trade among unrelated companies in the same industry, and intrafirm trade among the units of a single corporate system—the latter now accounting for fully one-third of world trade and steadily increasing. As emphasized in describing the global factory, growth in worldwide trade in parts and components has outstripped that of global merchandise trade. This phenomenon derives from the spread of international producer-driven supply chains, where large multinational corporations fragment and relocate their manufacturing processes around the world for maximum efficiency, and then coordinate the resulting flow of parts, components, and final products. These networks are most common in capital- and skilled labor-intensive manufacturing industries (e.g., automobiles, electronics and information technology equipment, and heavy machinery). Because of the large-scale capital and up-to-date knowledge inputs they demand, entry into global production networks for such industries is difficult without external involvement, particularly FDI-financed affiliations.

SPILLOVER EFFECTS

FDI contributes to capital accumulation and economic growth and trade, but its full impact on development includes unique productivity-enhancing effects. Under the right conditions, major spillovers take place through technology transfer, human capital formation, and competition and enterprise development. FDI-financed foreign affiliates, their suppliers, and their host economy rivals are all potential recipients of such spillovers.

TECHNOLOGY TRANSFER

FDI brings new capital and improved technologies, production processes, and approaches to firm management and organization. This may be the most strategic single effect of FDI, since by definition developing countries face a technology gap, and multinational enterprises can supply know-how that helps these countries catch up.[19] For affiliates, FDI provides technology and knowledge inputs that directly raise productivity: firms with FDI perform better than those without it.[20] Technology transfer is also likely through vertical spillovers from foreign affiliates to local suppliers.[21] Training and technical advice to upgrade suppliers' productivity and product quality are the source of these inter-industry vertical spillovers. By contrast, intra-industry technology transfers—horizontal spillovers from foreign affiliates to local competitors through demonstration effects and labor mobility—seem less frequent.[22] For all spillovers to work, the distance between initial levels of technology in host country firms and those in foreign affiliates must not be too pronounced. The size of foreign ownership shares in affiliates may also have an effect. For example, joint ventures may promote more local sourcing and thus stronger vertical linkages than do wholly-owned foreign affiliates.[23] Intensity of competition, the quality of education in host countries, training and personnel policies in foreign affiliates, and

labor market structure and flexibility all influence the effectiveness of technology transfer. A strong market-oriented policy framework is also critical.[24]

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 foreign affiliates tends to be lower than among domestic firms in the same host economy, so the affiliates likely internalize most skills upgrading. Trained managers and technicians often move on to other jobs, however, stimulating broader benefits to the host economy. Training spillovers also occur through vertical linkages, and, when affiliates support industry and regional skill-building institutions, through horizontal linkages. Finally, when specialists formerly employed by foreign affiliates become independent entrepreneurs, they expand human capital.[25]

COMPETITION AND ENTERPRISE DEVELOPMENT

When a foreign affiliate enters a domestic market competition can increase, requiring all enterprises to become more efficient or else lose ground or even perish.[26] 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 helps ensure that heightened competition occurs within a rational, undistorted market environment.[27] 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.[28]

Though differing in kind, FDI's spillover advantages 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, appropriate legal and regulatory structures and rules must complement the discipline of open markets and trade.

In fact, the potential costs of FDI weigh most heavily on the host economy when these structures are absent. When better organized and more efficient foreign firms "crowd out" weaker domestic rivals, as noted above, adjustment entails real costs for displaced firms that must rapidly restructure to survive, and for displaced workers who must find new jobs. The solution is not to prevent the entry of FDI and preserve inefficiency, but to create a flexible business climate and labor market where local firms and workers can adapt to new conditions and opportunities, and to ensure that some social safety net measures exist to cushion adjustment.

FDI MOTIVATIONS AND DEVELOPMENT IMPACTS

All forms of FDI can generate capital accumulation, employment, and income growth, but not all transfer technology, upgrade human capital, and spur competition to the same degree. 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 economy's reputation for quality, reliability, and productivity. When efficiency-seeking manufacturers begin taking root they involve themselves with local suppliers to good effect. Likewise, both efficiency- and market-seeking service providers can indirectly raise the host economy'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 can have the same positive impact in host-country domestic markets, 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 global retailer chains like Carrefour or Wal-Mart have introduced new pricing approaches, marketing and merchandising methods, and inventory management processes into host economies. The resulting competition in local markets persuades local wholesalers and retailers to adopt new techniques, 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 may have a more 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 through backward linkages for the host country.[29] 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.[30] 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.[31] For example, FDI

- ***Expands 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.
- ***Boosts revenues for social programs.*** FDI generates tax revenues 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.
- ***Cushions 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.

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 even 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."[32] 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.[33] 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.[34]

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 nonbinding guidelines to help foreign enterprises operate in harmony with government policies and societal expectations. And more than 3,200 businesses and other stakeholders from 94 countries have signed to the UN's Global Compact, which sets forth principles of conduct in human rights and labor standards, among other concerns.[35]

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.[36] 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 level, 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 practice 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.[37] To maximize the likelihood that FDI does not harm or 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 foreign affiliates to regard good environmental practice as a spillover effect expected of FDI. On their side, multinational corporations should shape day-to-day operations and business strategies according to the provisions of the Environmental Chapter of the OECD Guidelines for Multinational Enterprises. The OECD has formulated tools and corporate approaches (e.g., environment management systems, stakeholder consultation, environmental assessments, contingency planning, training) in connection with this Chapter.[38]

3. TRENDS AND PATTERNS IN FDI FLOWS

Foreign direct investment inflows to developing countries rose more than seven-fold in the 1990s, then declined significantly in the first years of the new century as the world economy slowed and FDI flows from developed countries collapsed. FDI activity has been recovering, and overall developing world inflows rapidly reached new highs. Behind such general trends, FDI's distribution in the developing world is uneven, by country, by countries grouped by income level, and by major region. Recognizing FDI's broad patterns and geography is essential to understanding how FDI fits in the developing world, and to establishing a context for analyzing future flows.

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. Flows between developed countries, especially across the Atlantic, increased. Extractive and commodity FDI flows to developing countries continued, but with a gradual rise in market-seeking manufacturing FDI. By 1970 developing countries absorbed one-third of global FDI stock.

1970–1990. Manufacturing investment in developing countries increased, but developing countries' share of global FDI stocks declined from 40 percent in 1985 to 25 percent in 1990.

1990–2000. The steady increase in volume of flow to developing countries was eclipsed by a phenomenal rise in flows between developed countries. Service sector FDI flows to developing countries rise gradually to 40 percent of FDI by 1999. The shares of Asia (especially China) in manufacturing and Latin America in services and utilities also rose. Africa remained marginalized.

2001–2006. FDI inflows decreased with worldwide recession after the "dot-com" crash. All FDI activity dropped severely, and then rebounded after 2003, with record high inflows achieved by 2005 for developing countries in all regions but Latin America. Early data suggest that inflows have continued to rise in 2006.

OVERALL TRENDS

Developing countries now host $285 billion in FDI inflows, or about 31 percent of the $916 billion in worldwide inflows recorded in 2005.[1] Though still below the performance of the mid- to late-1990s, this share is still much larger than that held by the developing economies at the beginning of the 1990s (Table 3-1). The past 15 years show that in good economic times and bad FDI is a persistent force in the developing world.

1990S DECADE OF MASSIVE INFLOWS

FDI inflows to developing countries rose from $26 billion in 1990 to $188 billion in 1999, an increase of nearly 630 percent.[2] Five factors seemed to account for this surge:

1. Extensive investments 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.

Table 3-1

Total FDI Inflows, Worldwide and Developing Countries by Region, 1970, 1980, and 1990–2005 (US$ billion)

			Developing Countries[b]						
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	13.4	10.0	3.4	0.4	0.1	1.5	0.5	0.1	0.8
1980	55.3	46.3	9.0	1.7	0.1	6.4	0.4	0.2	0.3
1990	201.6	176.1	25.6	11.3	1.6	9.5	0.9	0.6	1.7
1991	154.8	120.3	34.5	13.7	4.9	11.5	1.4	0.4	2.6
1992	170.5	119.5	51.0	21.8	7.5	16.3	2.5	0.7	2.2
1993	224.1	150.3	73.9	39.7	11.6	14.6	3.7	1.1	3.0
1994	254.3	163.3	91.0	45.9	8.9	27.8	2.5	1.9	3.9
1995	340.3	229.8	110.6	54.3	17.7	30.1	1.3	2.7	4.4
1996	392.4	259.4	133.0	62.5	17.3	43.8	1.9	3.1	4.4
1997	489.7	314.4	175.3	65.8	24.7	66.2	5.0	5.4	8.3
1998	712.0	538.2	173.8	60.2	27.6	71.2	4.3	3.9	6.6
1999	1,099.9	912.7	187.2	52.2	29.7	88.4	4.5	3.2	9.2
2000	1,409.6	1,235.6	174.0	47.5	30.2	79.7	5.3	4.7	6.5
2001	832.2	650.0	182.2	50.5	32.9	70.6	6.8	6.4	15.0
2002	617.7	449.3	168.5	60.2	35.0	51.0	5.5	7.0	9.8
2003	557.9	389.3	168.6	60.1	36.9	42.8	8.5	5.7	14.5
2004	710.8	480.4	230.4	72.2	68.7	61.6	7.8	7.3	12.8
2005	916.3	631.1	285.1	89.7	81.2	68.4	15.8	9.8	20.2

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

[b] "Developed Countries" includes data on economies classified as high income by the World Bank (2005 per capita GNI of $10,726 or more). "Developing countries" includes data on economies classified as low or middle income by the World Bank (2005 per capita GNI of $10,725 or less).

SOURCES: FDI inflows data fromUNCTAD, *World Investment Report 2006*; World Bank, *World Development Report 2007* for country classifications.

3. A wave of ***international corporate cross-border 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 business environment.

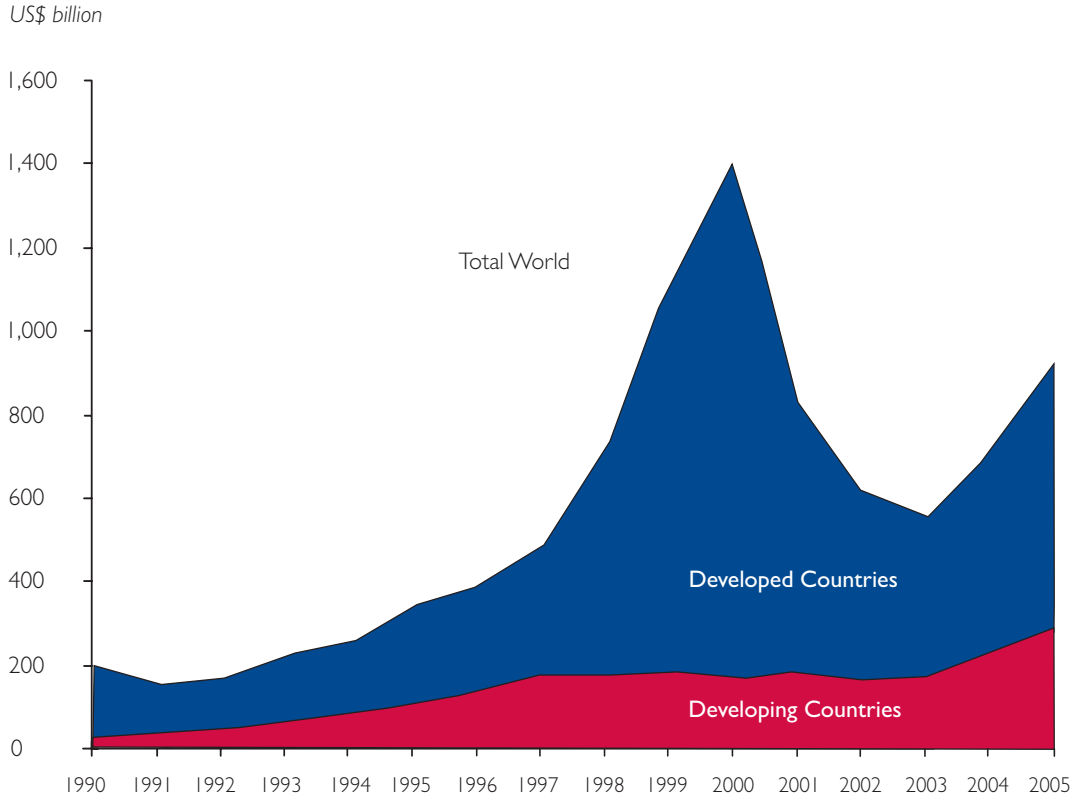
5. Worldwide ***economic liberalization***, in which trade flows grew rapidly and investment regimes became increasingly open to FDI.

The surge mirrored worldwide FDI growth: with massive expansion of FDI in the developed countries, global inflows rose from $202 billion in 1990 to more than $1.4 trillion in 2000, an increase of almost 600 percent (Figure 3-1).

YEAR 2000 PEAK AND SLUMP

After peaking in 1999/2000, FDI inflows in developed and developing countries declined over the next three to four years. In developed countries between 2000 and 2005, inflows plummeted 68 percent from a $1.2 trillion record high to $389 billion. The drop-off seems attributable to sluggish economic growth and poor stock market performance, a continuing decline in cross-border mergers and acquisitions, and widespread repayment of intracompany debt by the foreign affiliates of multinationals.

Figure 3-1
FDI Inflows, Developed and Developing Countries, 1990–2005



Note: "Developed countries" includes data on economies classified as high income by the World Bank (2005 per capita GNI of $10,726 or more). "Developing countries" includes data on economies classified as low or middle income by the World Bank (2005 per capita GNI of $10,725 or less).

Sources: UNCTAD, *World Investment Report 2006* data on FDI inflows; World Bank, *World Development Report 2007* for country classifications.

FDI inflows also fell in developing countries, but only by 10 percent from the 1999 peak of $187 billion and to $169 billion in 2003. The decline appears to have been largely a function of a drying up of FDI to middle-income economies, particularly in Latin America and South East Asia, as developed country multinationals retrenched; privatizations were concluded in the infrastructure, petroleum, and financial sectors; and 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 the low-income countries as a group, FDI inflows remained stable or increased slightly between 1999 and 2003. China and India, where inflows continued to rise after 1999, were major factors in this pattern.

2004–2005 RETURN TO GROWTH

After a four-year slump, FDI inflows to the developing world began to rise substantially. Growth in 2004 and 2005 has been dramatic—69 percent from the 2003 trough. Total FDI inflows now stand at $285 billion, a new record for the developing world. FDI activity also reignited and expanded in developed countries, though to levels considerably below the peak inflows of 2000.

Reasons for this turnaround are clear. Economic growth in the developed world, first in the United States and then in the European Union and Japan, produced major gains in developed country stock markets and sustained increases in corporate profits. This generated FDI activity worldwide. Much of the global increase in FDI took the form of large-scale cross-border M&A transactions by multinationals, particularly—but not exclusively—within the developed world.

Similarly, in the developing world, macroeconomic conditions have been favorable, with economic growth annually averaging 6 percent to 7 percent in real terms.[3] Economic expansion has been particularly robust in China (9.9 percent) and India (8 percent). Continuing business environment liberalization and policy reform, vigorous global trade expansion (10.6 percent in 2004 and 7.1 percent in 2005), and booming commodity prices, especially for oil (up 30.6 percent in 2004 and 41.5 percent in 2005), all fuel this growth. Rising corporate profits and stock markets in developing countries also contributed to the new flow of FDI deals.

MEDIUM-TERM PROSPECTS

For the rest of this decade developing countries as a group are likely to maintain the present record volumes of FDI inflows.[4] But the pace of growth may level off. According to a medium-term forecast by the Economist Intelligence Unit, total FDI inflows to developing countries reached a new peak in 2005 and will now rise by only about 7 percent by 2010, a far cry from the trajectory of the past two years. Some developing economies will certainly do much better than this (e.g., China, a global manufacturing export platform, and India, a world leader in IT services exports, and both also attractive for their mass domestic markets).

The factors favoring current sustained high levels of FDI inflow for the rest of the decade appear to be the same ones that generated the recent reversal: continuing global economic recovery and robust trade expansion, strong demand for key commodities, progress in liberalizing markets and investment climates, and worldwide competitive pressures to achieve cost efficiency. Multinationals' interest in cross-border M&As in the developing and developed worlds, and ample financial liquidity for such activity, will also sustain inflows. A continuing shift toward FDI in services, where cross-border investment opportunities may still be untapped and where various developing countries may seek to attract FDI to upgrade infrastructure standards, will be important to support M&A activity.

Of course, prospective FDI flows face risks. Economic nationalism and protectionism seem to be gaining strength in the developed and developing world alike, and might begin to

undo improvements in investment climates. The completion of many major privatizations in Eastern and Central Europe and Latin America may now leave a pipeline of relatively more complex and slower maturing M&A opportunities. Inflationary pressures and extended periods of very high oil prices could disrupt global growth, and tip the world economy into recession. And large-scale terrorist attacks or outbreaks of disease (e.g., Avian Flu) could seriously affect global business and investment activity. All of these risks temper growth prospects, and unmanaged, any could very negatively affect future FDI activity.[5]

SOURCES OF FDI

FDI flows to developing countries are in large part a function of economic performance in developed countries. High-income economies, both OECD and non-OECD members, generate about 63 percent of all FDI flows to the developing world. Assuming outflows to developing countries roughly follow UNCTAD's profile of total global FDI outflows by country source for the period 2003 through 2005, the five largest providers of FDI capital are the United States, United Kingdom, France, Netherlands, and Japan.[6] Among non-OECD high-income countries, Singapore, Taiwan, and Hong Kong are important sources. The balance of FDI outflows are from developing countries (Figure 3-2). Such "South–South" flows—including those originating in the BRIC countries (Brazil, Russia, India, and China)—are increasingly significant to the developing economies, as will be seen in Chapter 4.

COUNTRY CONCENTRATION OF RECIPIENTS

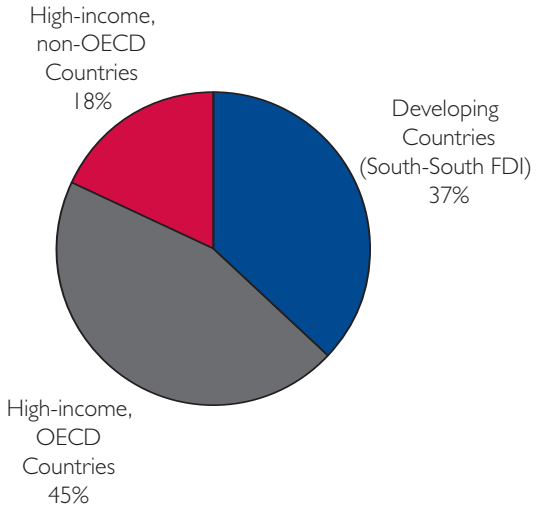
FDI is often cited as an indicator of globalization's spread and influence, but most FDI flows to the developing world are highly concentrated among a few countries. According to UNCTAD, about 150 developing economies hosted FDI inflows in 2005. But about 60 percent of receipts, some $173 billion, was directed to only ten countries (Table 3-2). China alone, receiving $72 billion in 2005, accounts for more than one-quarter of all inflows to developing countries. Of course, as much as 40 percent of China's inflow may be attributable to mainland firms "round-tripping" domestic investment through Hong Kong to take advantage of conditions and incentives open only to foreign investors.[7] But even factoring out this effect, China's inflows still nearly match the combined total of the next three largest countries in the top ten—Mexico, Brazil and Russia—each with receipts from about $15 billion to $18 billion.

Inflows to the next ten largest recipients accounted for only $52 billion, or 18 percent of all FDI. The remaining $60 billion or 22 percent was divided among 126 developing countries.

Country concentration, however, appears to be weakening. The ten top recipients garnered 73 percent of FDI inflows in 2000, but only 60 percent in 2005. Over this same period, the combined share for the next ten recipients increased from 11 percent to 18 percent. And the remaining 126 countries increased their share of inflows from 16 percent in 2000 to 21 percent in 2005. This dilution reflects many factors, among them an intensifying search for resources throughout the developing world, but also the steady spread of investment climate reforms, which has increased the number of attractive FDI destinations.

In addition, concentration seems less important when FDI is measured by indicators other than dollar value. For example, if 2005 FDI inflows to the top 20 recipients in absolute terms are calculated as a proportion of GDP, China is outperformed by Ukraine (9.6 percent), the Czech Republic (8.9 percent), and Colombia (8.3 percent). And, if FDI inflows to the top 20 recipients are calculated on a per capita basis, the standard is set by the Czech Republic with $1,078 FDI per capita, followed by Hungary ($664) and Chile ($409). China posts only about $56 per capita (Table 3-2). Equatorial Guinea, with

Figure 3-2
Estimated Share of Sources of FDI Inflows to the Developing World, 2003



Note: Based on 35 countries that account for 85 percent of total FDI flows to developing countries (economies classified as low or middle income by the World Bank).

SOURCE: World Bank, *Global Development Finance 2006*, Volume I, p. 111.

523,000 people and an oil-sector-induced FDI inflow of $1.9 billion in 2005, recorded an estimated per capita FDI of $3,676 for the year, the developing world's highest figure.

DISTRIBUTION BY COUNTRY INCOME LEVEL

FDI is often described as a source of capital for mainly middle-income countries, meaning that low-income countries need to look elsewhere to finance development. This generality bears a closer look (Appendix Table A-1).

The 95 countries categorized as "middle-income" by the World Bank receive more than 90 percent of FDI inflows to the developing world (Figure 3-3). But when this category is divided into "lower middle-income" and "upper middle-income," it becomes clear that for the last 15 years, half or more of all FDI flows were consistently directed to economies with a present per capita GNI of $3,465 or less (the ceiling for lower middle-income countries). The importance of Southeast Asia's 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 leads to this result. The pattern was broken only briefly in the late 1990s by the wave of large-scale Latin American privatizations and M&As in services and banking, led by Brazil, Mexico and Argentina, all middle-income economies.

On the other hand, the very poorest countries receive relatively little FDI. Using the UN's list of 50 "least developed countries" (LDCs)[8] as the standard, over the last five years, these poorest economies have together hosted only between $7 billion and $11 billion in FDI inflows annually, or about 4 percent of all FDI inflows to the developing world. Here again, FDI receipts are concentrated. Resource-seeking petroleum-sector FDI inflows to only four LDCs—Angola, Chad, Equatorial Guinea, and Sudan—made up 57 per-

Table 3-2

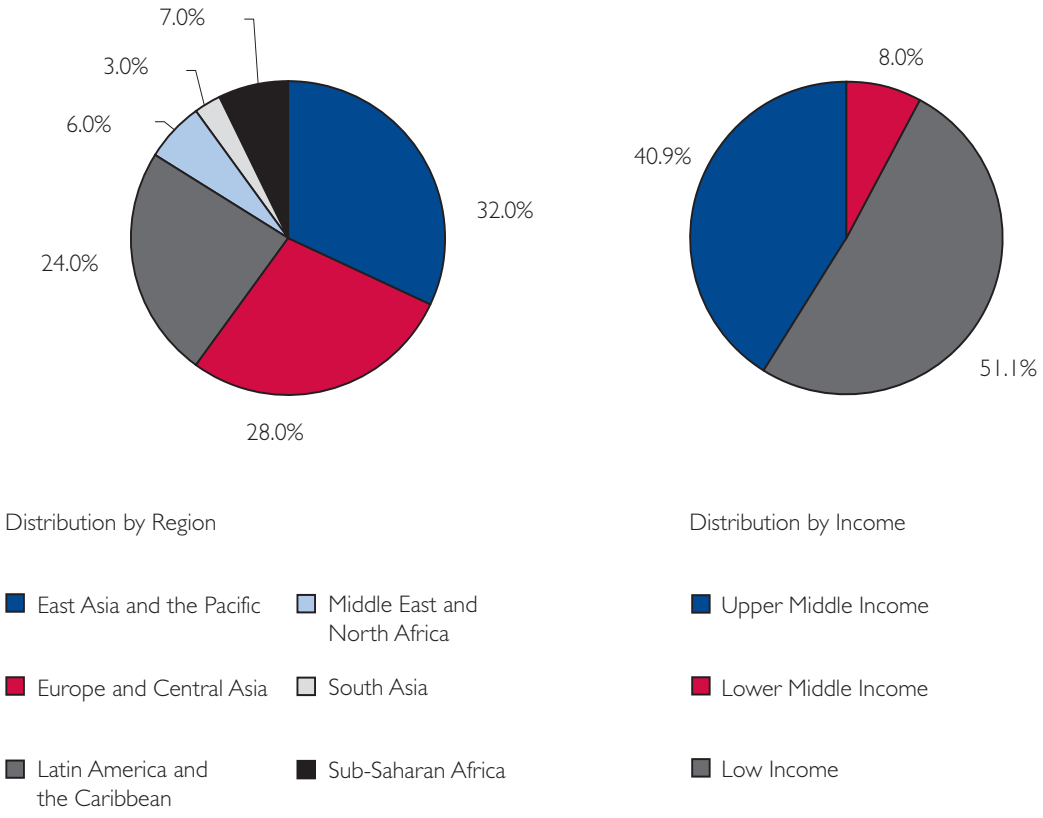
Top Developing Country Recipients of FDI, 2000 and 2005, and FDI Per Capita and as a Percent of GDP

2000			2005				
					FDI		
Recipients	Income Classification	FDI ($ billions)	Recipients	Income Classification	$ Billions	Per capita ($)	% GDP
All Developing		182.2	All Developing		285.1		
Top 10			Top 10				
China	LMI	40.7	China	LMI	72.4	56	3.3
Brazil	LMI	32.8	Mexico	UMI	18.1	175	2.3
Mexico	UMI	17.6	Brazil	LMI	15.1	81	1.9
Argentina	UMI	10.4	Russian Fed.	UMI	14.6	102	1.9
Poland	UMI	9.3	Czech Republic	UMI	11.0	1078	8.9
Czech Republic	UMI	5.0	Colombia	LMI	10.2	224	8.3
Chile	UMI	4.9	Turkey	UMI	9.7	133	2.7
Venezuela	UMI	4.7	Ukraine	LMI	7.8	166	9.6
Malaysia	UMI	3.8	Poland	UMI	7.7	202	2.6
India	LI	3.6	Hungary	UMI	6.7	664	6.1
Total		132.8	Total		173.2		
% of Dev. Country Total		72.9	% of Dev. Country Total		60.8		
Next 10			Next 10				
Thailand	LMI	3.4	Chile	UMI	6.7	409	5.9
Hungary	UMI	2.8	India	LI	6.6	6	0.9
Russian Fed.	UMI	2.7	Romania	UMI	6.4	295	6.5
Colombia	LMI	2.4	South Africa	UMI	6.4	141	2.7
Philippines	LMI	2.2	Egypt	LMI	5.4	73	5.8
Slovakia	UMI	1.9	Indonesia	LMI	5.3	24	1.9
Nigeria	LI	1.3	Argentina	UMI	4.7	120	2.6
Viet Nam	LI	1.3	Malaysia	UMI	4.0	157	3.0
Kazakhstan	LMI	1.3	Thailand	LMI	3.7	57	2.2
Egypt	LMI	1.2	Nigeria	LI	3.4	26	3.4
Total		21	Total		52		
% of Dev. Country Total		11.3	% Dev. Country Total		18.4		

Note: Includes only economies classified as low or middle income by the World Bank (2005 per capita GNI of $10,725 or less). Income groups are defined according to per capita gross national income in 2005: low income, $875 or less; lower middle income, $876–3,465; upper middle income, $3,466–10,725; high income, $10,726 or more.

SOURCES: UNCTAD, *World Investment Report 2006* for data on FDI inflows; World Bank, *World Development Report 2007* for country classifications.

Figure 3-3
FDI Inflows to the Developing World, by Income Level and Region, 2005



Notes: Includes only economies classified as low or middle income by the World Bank (2005 per capita GNI of $10,725 or less). Income groups are defined according to per capita gross national income in 2005: low income, $875 or less; lower middle income, $876-3,465; upper middle income, $3,466-10,725; high income, $10,726 or more.

SOURCES: UNCTAD, *World Investment Report 2006* for data on FDI inflows; World Bank, *World Development Report 2007* for country classifications.

cent of all LDC inflows between 2001 and 2005.

REGIONAL PATTERNS

Still another way to understand the flow of FDI is to trace its distribution among the six regions of the developing world, as defined by the World Bank.[9] In the recent resurgence of FDI, all six regions experienced increased inflows, and all but Latin America and the Caribbean achieved new peaks in FDI (Table 3-3). At present, East Asia and Pacific is the single largest FDI host region, regaining the rank it had lost to Latin America and the Caribbean from 1997 to 2001. South Asia hosts the least amount of FDI in the developing world (Figure 3-3). A brief examination of FDI inflows of the past few years provides insights into factors that influence FDI receipts in developing economies.

EAST ASIA AND THE PACIFIC—CHINA'S APPEAL

Powered by China's high GDP growth, FDI inflows to the East Asia and Pacific region have risen steadily since 2000, in the past five years accounting for about one-third of all FDI flows to the developing world. China absorbs the biggest portion of the regional total: 86 percent during 2001–2005. ASEAN members Malaysia,

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 intracompany loans. This reduces FDI inflows. Lower equity values tied to stock market dips also discourage mergers and acquisitions.

Institutional factors. Trade policy and investment climate liberalization and regulatory reform strongly encourage FDI. Privatization programs in the 1990s, especially in Latin America, Eastern Europe, and the Former Soviet Union, were a major institutional boost to FDI. The rapid rise in private participation in infrastructure (BOTs, BOOs, etc.) in Asia was another. With the end of large privatizations and investors' reawakening to emerging market risk after the Asian Financial Crisis privatizations and infrastructure-related FDI both dropped off sharply. See UNCTAD, *WIR 2003*, pp. 15-19. World Bank, *GDF 2004*, pp. 154-161.

Table 3-3

Summary of Total FDI Inflows to the Developing World, by Region, 2000-2005 (US$ billion)

Region	2000-2005	2000	2001	2002	2003	2004	2005
East Asia and the Pacific	380.3	47.5	50.5	60.2	60.1	72.2	89.7
Europe and Central Asia	284.9	30.2	32.9	35.0	36.9	68.7	81.2
Latin America and the Caribbean	374.2	79.7	70.6	51.0	42.8	61.6	68.4
Middle East and North Africa	49.7	5.3	6.8	5.5	8.5	7.8	15.8
South Asia	40.9	4.7	6.4	7.0	5.7	7.3	9.8
Sub-Saharan Africa	78.8	6.5	15.0	9.8	14.5	12.8	20.2
Total	1,208.8	174.0	182.2	168.5	168.6	230.4	285.1

Notes: Includes only economies classified as low or middle income by the World Bank (2005 per capita GNI was $10,725 or less).

SOURCES: UNCTAD, *World Investment Report 2006* for data on FDI inflows; World Bank, *World Development Report 2007* for regional groupings.

Thailand, Vietnam, Philippines, and Indonesia make up most of the balance (see text box). While these ASEAN nations all experienced significant FDI increases in the last couple of years, none has regained the peak flows of the 1990s, before the impact of the Asian Financial Crisis.

FDI to East Asia and the Pacific 2001–2005

	FDI Inflows ($mn)		FDI % GDP
	2005	2001–2005	2001–2005
Region Total	89,700	332,736	3.1
China	72,406	286,161	3.7
Malaysia	3,967	14,822	2.8
Thailand	3,687	11,886	1.7
Vietnam	2,020	7,580	3.7
Philippines	1,132	4,048	1.0
Indonesia	5,260	3,726	0.4
Other (17 countries)	1,228	4,512	2.3
Developing Countries	285,144	1,034,754	2.8

SOURCE: UNCTAD, *WIR 2006*; World Bank regional groupings.

FDI to China increased twenty-fold over the past 15 years, largely because of export-oriented industry that benefits from China's low labor costs and pro-FDI special economic zones. In 2005, foreign-invested enterprises—3 percent of all companies—generated 57 percent of the China's exports and 88 percent of its high-tech exports.[10] Since joining the WTO in 2001, China has intensified its economic liberalization program, progressively relaxing geographical restrictions on FDI and opening more flexible foreign ownership opportunities in domestic industries, including banking, insurance, telecommunications, wholesale and retail trade, and tourism. With an eye on China's enormous domestic markets, foreign investors have responded accordingly. Their reaction has been especially striking in financial services, where market-seeking FDI has engaged in cross-border M&A with state banks, megatransactions valued at more than $12 billion in 2005 alone. At the same time, efficiency-seeking FDI in manufacturing continues to flow heavily to China, although rising wages, land costs, and input prices appear to have depressed earnings, and may encourage some moves away from assembly operations to higher skill, higher value-added activities, as well as some relocation to new production areas.

Some ASEAN nations fear that China's success will reduce their own FDI flows, especially with China's accession to the WTO. Recent research, however, indicates that FDI in China and in East Asia are generally complementary: China's rising FDI correlates with increases in FDI inflows elsewhere in East Asia, reinforcing the view that China and ASEAN economies operate within common production networks. Market size and policy variables (e.g., low corporate taxes and FDI openness) seem to be more critical for FDI attraction than the "China effect."[11] In fact, in the years since the regional lull in FDI inflows in 2002, with Indonesia, Thailand, Malaysia, and Vietnam in the lead, East Asian economies other than China have together generated one-third of the growth increment in regional FDI, well above their share of inflows. A combination of economic reform, political stability, aggressive incentives, high commodity prices, and prospective WTO membership (for Vietnam) all probably contributed to this performance.

In the medium term, given its size and momentum, China will likely continue to attract massive inflows and capture the largest proportion of regional FDI, especially in services and in higher-value, capital-intensive manufacturing. How quickly China meets its WTO commitments to liberalize services and improve the business environment will be an important determinant of regional FDI growth. Escalating operating costs in China may encourage some relocation of labor-intensive export manufacturing. If so, regional economies will probably benefit first, particularly Vietnam, which can offer low cost labor and the dynamism of new WTO membership. Continuing economic liberalization and reform, and advances in ASEAN's program for regional economic integration, could

help maintain and perhaps even add to FDI levels throughout the region.

EUROPE AND CENTRAL ASIA—EU AND OIL-GAS

Over the past ten years, FDI inflows to Europe and Central Asia have risen 350 percent, a 49-fold increase since 1990. The worldwide FDI slump at the beginning of the 2000s dampened but did not stop this growth, and the escalation of inflows since that period has been the most rapid of all developing regions, reaching a new peak in 2005. Together, European and Central Asian economies have accounted for about a quarter of all FDI inflows to the developing world in the last five years, and this share is growing. Russia, Czech Republic, Turkey, Ukraine, Poland, Hungary, Romania, Kazakhstan, and Azerbaijan have been the major regional hosts for FDI, each with total inflows of more $10 billion since 2001 (see text box).

FDI to Europe and Central Asia 2001–2005

	FDI Inflows ($mn)		FDI % GDP
	2005	2001–2005	2001–2005
Region Total	81,176	254,688	3.4
Russia	14,600	44,212	1.8
Poland	7,724	35,031	3.1
Czech Republic	10,991	32,191	7.1
Hungary	6,699	20,420	5.0
Turkey	9,681	18,759	1.5
Romania	6,388	17,419	5.5
Kazakhstan	1,738	13,368	7.7
Ukraine	7,808	12,432	4.5
Azerbaijan	1,680	10,141	25.4
Other (18 countries)	13,868	50,715	4.8
Developing Countries	285,144	1,034,754	2.8

SOURCE: UNCTAD, *WIR 2006*; World Bank regional groupings.

Two factors influence FDI inflows to the region. First, for the Eastern European and Baltic states, accession to the EU has been a principal FDI driver. Economic restructuring and liberalization in the run-up to accession, including the lowering of corporate tax rates and the adoption of EU laws and regulations, sharply improved business climates. It also provided a stream of major privatization opportunities for public utilities, financial services, and other sectors. And proven manufacturing capacity, soon to be absorbed into the EU market and manned by a low-wage, well-educated workforce, has been a powerful attraction for FDI. As a result, both FDI-powered manufacturing for export and services have grown rapidly in Eastern Europe (e.g., an excellent automobile manufacturing cluster in the Czech Republic, Hungary and Slovakia). At present, this same "EU effect" seems to be at work for the new members and members-to-be—Romania, Bulgaria, and Croatia—as the recent ramp-up of Romania's FDI receipts shows ($6.6 billion in 2005). Second, for the resource-rich economies of the region (e.g., Russia, Kazakhstan, Azerbaijan), FDI in search of oil and gas as well as other minerals and natural resources has been another key driver. Since 2000, Kazakhstan and Azerbaijan together have attracted more than $23 billion, about 10 percent of the region's total FDI inflows. A good portion of Russia's $36 billion FDI receipts during this period is tied to oil and other natural resources.

These same variables—access to the EU market and natural resources—will likely continue to make the region a dominant FDI destination for the medium term. In addition, Russia's special combination of natural resources, large domestic market and potential production cost-efficiencies, along with its accession to the WTO, should guarantee sustained growth in its FDI inflows. Here, though, a persistent pattern of state interference in business along the lines of the Yukos affair could compromise investor confidence

LATIN AMERICA AND THE CARIBBEAN—MAJOR MARKETS AND NEW MOMENTUM

Between 1997 and 2001, Latin America and the Caribbean captured 42 percent of FDI inflows to the developing world. Brazil, Mexico, Argentina, and (more modestly) Chile received the most FDI. After achieving a peak of $88 billion in FDI in 1999, the region suffered a protracted economic downturn—including a severe financial crisis in Argentina in 2001/2002—that

depressed regional FDI for several years. Since 2003, FDI inflows have risen sharply although the region as a whole and most of its member economies have yet to restore or significantly exceed the inflows of the late 1990s. Mexico and Brazil are the second and third largest FDI country recipients in the developing world, but by 2005 Latin America and the Caribbean still ranked third as a region in FDI inflows to developing economies (see text box). This is largely

FDI to Latin America and Caribbean 2001–2005

	FDI Inflows ($mn)		FDI % GDP
	2005	2001–2005	2001–2005
Region Total	68,446	294,476	3.0
Mexico	18,055	96,339	2.9
Brazil	15,066	82,403	2.9
Chile	6,667	24,897	6.0
Colombia	10,192	19,731	4.3
Argentina	4,662	14,903	1.8
Venezuela	2,957	11,599	2.1
Other (25 countries)	13,868	44,604	3.1
Developing Countries	285,144	1,034,754	2.8

SOURCE: UNCTAD, *WIR 2006*; World Bank regional groupings.

because Brazil and Argentina are still attracting far less FDI than they did in the 1990s.

Recent renewal in regional FDI is due to several factors: a rebound in the world and U.S. economy, a return to economic growth throughout the region, sharply higher commodity prices, a new wave of cross-border M&As, and rising corporate profits for foreign affiliates, notably in mining, that have translated into greatly increased flows of FDI in the form of reinvested earnings. The regional profile of FDI that results from this decade's resurgence differs from that of the record flows of the 1990s. Then, a large volume of FDI transactions aimed at privatizing public utilities (particularly in Brazil and Argentina), plus NAFTA-generated *maquila* FDI projects (in Mexico), led inflows. Now, FDI growth generally appears to have a smaller services component, with fewer public utilities privatizations, and is directed more to private sector market-seeking M&As, natural resources, and manufacturing projects.

In Mexico, maquila-oriented FDI continues in autos and electronics, but often in higher skill and value-added activities than before, to better meet Asian competition. Liberalization in financial services has also stimulated cross-border M&As in banking. Brazil's FDI has been directed toward mining and other natural resources, domestic markets (e.g., a $4 billion cross-border M&A in the brewery industry), wholesaling and retailing, pharmaceuticals, and auto manufacturing for export. Argentina has attracted FDI in petroleum, and manufacturing for autos and food and beverages. Chile, with one of the world's most pro-FDI policy regimes and the region's highest FDI/GDP ratio, attracts a broad array of FDI flows to mining, manufacturing, telecoms, and other services. Colombia, Peru, and Ecuador all benefited from FDI for mining, oil, and gas. Two huge cross-border M&As in brewing and banking helped Colombia achieve new annual record inflows in 2005.

A combination of growing domestic markets, continued demand for natural resources, business environment improvements, and new or prospective free trade agreements with the United States (for Colombia, Peru, and the Central American economies) and with others (e.g., Mexico–Japan, China–Chile) would support present or even slightly increased FDI levels over the medium term. Some of the new flows may be "South-South," provided by regional multinationals investing in the region (e.g., intra-MERCOSUR). On the other hand, discouragements to FDI could include economic nationalism spreading beyond Venezuela and Bolivia, stalled structural reforms, intensified public utilities regulatory risk arising from investor-state disputes in Argentina and elsewhere, vigorous competition from manufacturers in East Asia, and perennial infrastructure deficiencies.

MIDDLE EAST AND NORTH AFRICA—OIL AND TRADE OPPORTUNITIES

Since 2000, FDI inflows to the Middle East and North Africa have more than doubled the level of the previous five-year period. FDI inflows

shot up to almost $16 billion in 2005, a new peak, but still representing only about 4 percent of all developing country inflows. Lebanon, Morocco, and Egypt recorded among them two-thirds of the region's total inflows between 2001and 2005, and Algeria, Jordan, and Tunisia another quarter (see text box). General regional growth has occurred despite instabilities created by the Iraq War and the Palestinian conflict. In fact, Morocco and Lebanon experienced an upsurge in FDI inflows in 2003. Instability no doubt severely depressed FDI receipts in other regional economies: Iraq of course, but also Iran, Yemen and Syria.

FDI to Middle East and North Africa 2001–2005

	FDI Inflows ($mn)		FDI % GDP
	2005	2001–2005	2001–2005
Region Total	15,840	44,383	1.7
Lebanon	2,573	10,119	10.7
Morocco	2,933	9,841	4.6
Egypt	5,376	8,927	2.0
Algeria	1,081	4,775	1.3
Tunisia	782	3,313	2.7
Jordan	1,532	2,831	5.4
Other (8 countries)	3,877	4,577	0.3
Developing Countries	285,144	1,034,754	2.8

SOURCE: UNCTAD, *WIR 2006*; World Bank regional groupings.

Several factors probably drive FDI to the region. First, resource-seeking FDI has been particularly important for oil and gas producers such as Algeria, Egypt, and Tunisia. Second, soaring oil prices have provided liquidity to encourage non-developing country direct oil producers in the Gulf (e.g., Kuwait) to invest in regional economies, such as Jordan and perhaps Lebanon, in sectors such as real estate, construction, and tourism. Third, the proximity of the EU market and the trade relationships created by various Euro-Mediterranean Association Agreements—EU with Morocco, Tunisia, Egypt, and Jordan—have promoted export-oriented manufacturing FDI in several countries. Other free trade agreements, such as the Jordan–US agreement that stimulated large-scale garment manufacture, may have encouraged FDI inflows. Finally, economic liberalization programs, including privatizations, have attracted FDI in several economies. Morocco privatized its Régie des Tabacs in 2003, for example, and Jordan privatized electric power and telecommunications utilities with UAE investors in 2005.

With high prices for oil and other commodities, favorable trends in world and EU economic conditions and trade, and momentum for economic reform improving regional business environments, recent levels of FDI inflow can be sustained over the medium term. A booming world petroleum sector could mean increased FDI for Algeria and Libya, the latter with very significant potential to attract FDI after years of economic sanctions. By contrast, persistence of current tensions and strife in Lebanon would discourage FDI inflows to that key economy and perhaps to the region as a whole.

SOUTH ASIA—INDIA'S LEAD

FDI inflows to South Asia have increased over the past decade, but much more slowly than for the developing world as a whole. South Asia attracted nearly $10 billion in 2005, a record, though still less than 4 percent of all FDI flowing to developing countries (see text box). Regional growth has been due almost entirely to India, whose FDI receipts hit $6.6 billion in 2005, and whose inflows over the five years account for nearly 77 percent of the regional total. Pakistan is a distant second destination with about $2.2 billion in 2005 and 14 percent of total regional inflows since 2001. Other destinations, such as Bangladesh and Sri Lanka, have had fairly limited inflows, though both boast quite liberal frameworks for FDI. Political tension, corruption and poor infrastructure in the former, and prolonged civil strife in the latter, have constrained FDI.

India's major FDI inflows have gone to IT, telecommunications, manufacturing, and industry. But much of its IT-enabled services and computer software enterprises have grown less through FDI than through nonequity contract-

FDI to South Asia 2001–2005

	FDI Inflows ($mn)		FDI % GDP
	2005	2001–2005	2001–2005
Region Total	9,765	36,193	0.9
India	6,598	27,756	0.9
Pakistan	2,183	5,041	1.2
Bangladesh	692	2,185	0.8
Other (5 countries)	292	1,211	0.8
Developing Countries	285,144	1,034,754	2.8

SOURCE: UNCTAD, *WIR 2006*; World Bank regional groupings.

ing mechanisms. India's economic liberalization program, first begun in 1991 and reinforced in 1995 by the opening of 111 sectors to FDI, continues to unfold. In the last few years, restrictions on FDI have been progressively lifted in several sectors, including energy, telecommunications, air transport, banking, and insurance. FDI is nevertheless still excluded from multibrand retailing, an important sector for multinationals. India has also undertaken FDI institutional reform, creating in 2004 an Indian Investment Commission. India has become a source of FDI, with growing outflows to developing and developed country destinations. In Pakistan, FDI has been directed to privatization programs in telecommunications, energy, and banking.

India holds the key to nearly all future FDI inflows to South Asia. With its achievements in the IT sector and massive domestic markets, it consistently scores high as a favored future destination of multinationals' investment dollars.[12] IT-enabled services, telecommunications, automobiles, petroleum, insurance, and transportation are all likely investment targets. Given the size of its economy and population, current FDI flows lag well below potential: India's per capita FDI inflows amounted to $6 in 2005 and its FDI flows were only 0.9 percent of GDP vs. $56 and 3.7 percent for China. Growth in FDI will depend on the pace of liberalization, including streamlining labor regulations and government bureaucracy, and the upgrading of infrastructure. Pakistan will likely add modestly to regional FDI inflows in the medium term, particularly through privatizations in the oil and gas and telecommunications industries, as well as electricity and other public utilities.

SUB-SAHARAN AFRICA—THE OIL FACTOR

In 2005, the 47 countries of this region attracted $20.2 billion in FDI, a record for the region and about 7 percent of the developing country total. Over the past five years, six countries—South Africa, Nigeria, Sudan, Angola, Equatorial Guinea and Chad—accounted for more than 70 percent of regional FDI inflows (see text box). FDI has been largely resource-seeking, particularly in oil and gas, but also minerals. Heavily influenced by petroleum and other commodity prices, inflows have been erratic over the past decade. FDI activity has involved greenfield projects and cross-border M&As. This oil and gas-oriented FDI has mostly resulted in enclave investments, weakly tied to the host economy.

FDI to Sub-Saharan Africa 2001–2005

	FDI Inflows ($mn)		FDI % GDP
	2005	2001–2005	2001–2005
Region Total	20,216	72,278	3.2
South Africa	6,379	15,458	1.8
Nigeria	3,403	11,019	3.3
Angola	-24	8,748	10.7
Sudan	2,305	6,452	7.0
Equatorial Guinea	1,860	6,223	36.2
Chad	705	3,280	21.6
Other (41 countries)	5,588	21,098	2.5
Developing Countries	285,144	1,034,754	2.8

SOURCE: UNCTAD, *WIR 2006*; World Bank regional groupings.

With a relatively developed and diversified economy, South Africa has been the main exception to the oil-gas foundation of the region's FDI. The region's single largest FDI host ($6.4 billion in 2005), South Africa has absorbed 21 percent of regional FDI since 2000. Inflows have been directed at mining, manufacturing, and services. Over the past decade South Africa has built an automotive production hub of vehicles and components for export, drawing on FDI by several global auto multinationals. It has also attracted significant M&A in telecommunica-

tions and finance, including recent investments by Vodafone in Vodacom (mobile telephony) and Barclays in ABSA (bank), the latter valued at $5 billion.

FDI inflows to the rest of the region have been directed at resource-based projects, infrastructure privatizations, banking, and some manufacturing, including textile and apparel (though this has declined since the end of the Multifibre Arrangement or MFA. See "Future FDI Directions—Other Drivers" in Chapter 4). Few other countries have averaged as much as $250 million in annual inflows since 2001, and most have hosted inflows of less than $25 million.

In the medium term, regional FDI receipts will continue to be a function of the oil and gas sector and South Africa's economic performance. Future FDI inflows elsewhere are uncertain because of low labor productivity, poor infrastructure, small markets and weak regional integration, political instability, AIDS, and an urgent need for investment climate reform. There are exceptions—Mozambique, Ghana, Tanzania, Botswana—where economic liberalization and opportunities in natural resources, light manufacturing, tourism and privatization

4. FDI DRIVERS AND FUTURE DIRECTIONS

Macroeconomic forces, global production chains, technology advances, and host-country conditions broadly determine the size and location of foreign direct investment throughout the world. The result is a constantly shifting set of sectoral and industry destinations for FDI. But within these shifts, two fundamental trends have emerged. First, service sector activities now attract a majority of FDI inflows, globally and in developing countries. Second, developing countries as a group are increasing their share of worldwide FDI stock in all sectors, but not in all industries within sectors. These sector and industry trends, combined with other factors especially relevant to developing economies—the end of the Multifibre Arrangement, the dominance of China, the need to upgrade infrastructure systems, and increasing South-South investment links—will shape future FDI inflows in developing countries.

PROFILE OF FDI BY SECTOR

Worldwide FDI patterns have shifted markedly over the past 15 years. Comparing the 1990 and 2004 composition of inward FDI stock in developing and developed countries, at the sectoral and then the industry level, is revealing.[1]

DOMINANT ROLE OF SERVICES

Perhaps contrary to expectation—given popular images of China's vast FDI-fueled manufacturing industry—the services sector now accounts for the largest share of inward FDI stock in developing countries. The sector consists of conventional services, such as power, water, and other public utilities; telecommunications; finance and insurance; and retail and wholesale distribution. It also includes the new services of business support and other activities enabled by telecommunications and IT.

In developing countries, FDI in services increased substantially in the second half of the 1990s, growing at a much faster rate than FDI in manufacturing or natural resources. Services now represent nearly 60 percent of total inward FDI stock, up from 47 percent 15 years ago. Manufacturing represents roughly 30 percent, a decrease of nearly 15 points. Inward FDI stock in natural resources has also grown slightly in absolute and relative terms, but its share of 8 percent is still the smallest of the three sectors (Table 4-1). This evolving sectoral composition roughly parallels what has happened in the developed world in the same period, where concentration of FDI in services is a bit higher

Table 4-1
Sector Distribution of Estimated Inward FDI Stock, 1990 and 2004 (US$ billion)

	Primary		Manufacturing		Services		Other/ Unspecified		Total	
	$	%	$	%	$	%	$	%	$	%
Developing Countries[a]										
1990	23.7	7.3	144.4	44.6	151.6	46.8	4.1	1.3	323.7	100.0
2004	151.6	7.4	613.6	30.0	1224.4	60.0	52.5	2.6	2,042.1	100.0
CAAG[b]	14.2%		10.9%		16.1%		21.8%		14.1%	
Developed Countries										
1990	139.6	9.6	586.4	40.4	716.5	49.3	9.7	0.7	1,452.2	100.0
2004	268.2	3.6	2,406.1	32.7	4,624.7	62.9	53.8	0.7	7,352.8	100.0
CAAG	4.8%		10.6%		14.2%		14.1%		12.3%	
South-East Europe and CIS										
2004	20.7	25.2	20.4	24.9	34.3	41.7	6.7	8.1	82.2	100.0
World										
1990	163.3	9.2	730.8	41.1	868.1	48.9	13.8	0.8	1,775.9	100.0
2004	440.5	4.6	3,040.1	32.1	5,883.3	62.1	113.1	1.2	9,477.1	100.0
CAAG	7.3%		10.7%		14.6%		16.2%		12.7%	

[a] Country groups are those used by UNCTAD. UNCTAD classifies some countries as developing that the World Bank considers "high income," such as Singapore and South Korea, and classifies some as developed that the World Bank considers "low and middle income," such as Estonia, the Czech Republic and Hungary.
[b] Compound average annual growth.
[c] South-East Europe and CIS data are included in the world total for 1990, but are not available by sector and industry for that year.

SOURCES: Nathan Associates, based on UNCTAD, *World Investment Report 2006*, Annex Table A.1.2.

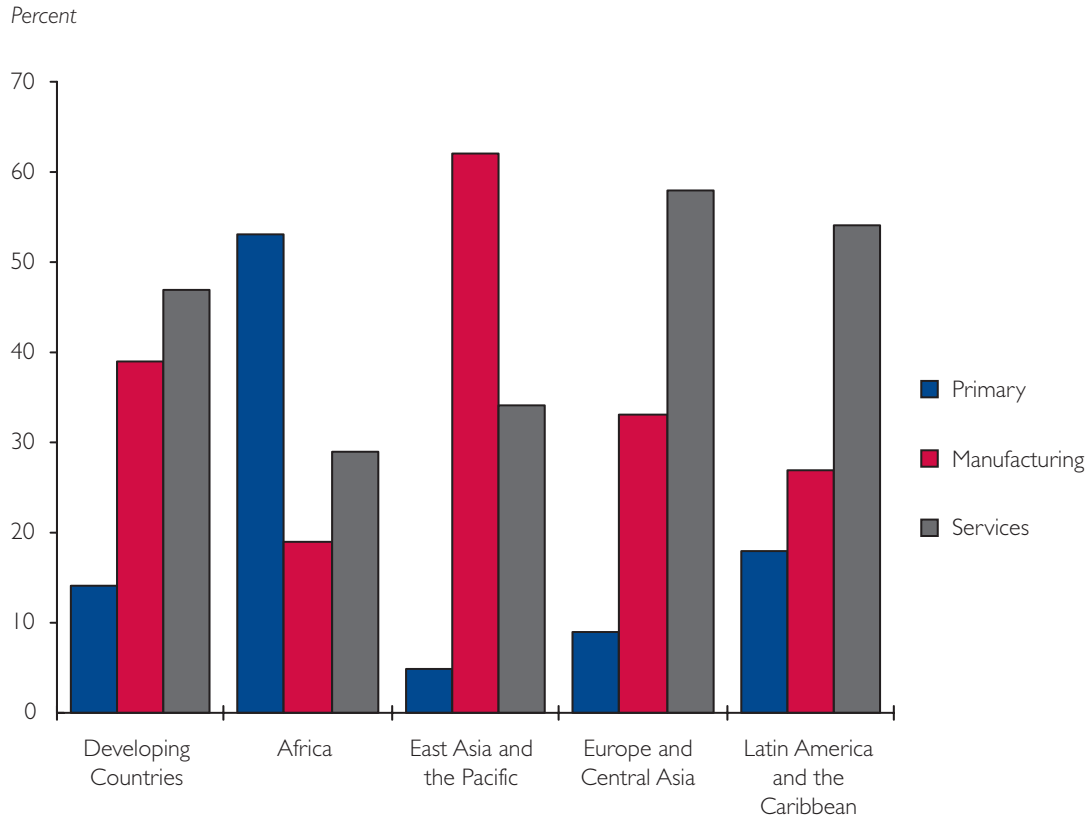
(almost 63 percent), having grown at the expense of both manufacturing (33 percent) and natural resources (4 percent).

The buildup of services FDI in the developing world differs by region. Investment has tended to flow to the wealthier upper-middle income economies, though exceptions exist (e.g., water services in Manila, Jakarta, or Conakry). Services therefore loom largest in the FDI stock of Latin America and the Caribbean and in Europe and Central Asia. In contrast, the major shares of inward FDI stock in East Asia and the Pacific and in Africa are in manufacturing and the primary sector, respectively (Figure 4-1). Such regional differences are logical: services become important as GDP rises; China is central to international manufacturing networks; and oil attracts the bulk of Africa's FDI.

INCREASING SHARES OF GLOBAL FDI STOCK

Just as the sectoral composition of FDI is changing, so too is the distribution of ***shares*** in total world inward FDI stock. The latest data suggest that since the beginning of the 1990s, developing countries as a group have increased their share of the world's inward FDI stock in all sectors. The largest gain has been in primary activities, with much more modest gains in services and manufacturing (Table 4-2). In all sectors the rate of growth of FDI inflows to developing countries has exceeded that of inflows to developed ones in the last 15 years. This is so despite

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, Harnessing Cyclical Gains for Development 2004*, p. 82.

the explosion of FDI inflows into the developed world in last half of the 1990s (Chapter 3, Figure 3-1).

MIXED PICTURE AT INDUSTRY LEVEL

While growth in developing country inward FDI stock has taken place at the sector level in absolute terms and relative to world stock, the picture at the industry level is more complex. Here the latest UNCTAD data highlight industries whose stock of inward FDI appears to be growing or shrinking over time relative to the size of world FDI inward stock. This in turn provides insights into where the providers of FDI capital may see emerging industry advantages or disadvantages for developing economies in relation to the developed world. The following are key conclusions:

Dramatic growth in absolute value. In the 30-plus industries whose inward FDI stock UNCTAD tracks, the developing world—developing countries and transition economies—increased the total absolute value of its inward FDI stock almost sevenfold between 1990 and 2004, from $324 billion to $2.1 trillion. 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 climbed from $144 billion in 1990 to $634 billion in 2004, an increase of nearly 340 percent. But since 1990 developing countries appear to have lost share in world FDI stock in several

Table 4-2
Estimated Developing Country Shares of World Inward FDI Stock, by Sector, 1990 and 2004

Sector	Developed Countries 1990(%)	Developed Countries 2004(%)	Developing Countries 1990(%)	Developing Countries 2004(%)	Change in Developing Countries' Shares
Primary	85.5	60.9	14.5	39.1	24.6
Manufacturing	80.2	79.1	19.8	20.9	1.1
Services	82.5	78.6	17.5	21.4	3.9
Other/Unspecified	70.3	47.6	29.7	52.4	22.7
Total	81.8	77.6	18.2	22.4	4.2

Note: Includes countries classified as "developing" by UNCTAD. UNCTAD classifies some countries as developing that the World Bank considers "high income," such as Singapore and South Korea, and classifies some as developed that the World Bank considers "low and middle income," such as Estonia, the Czech Republic, and Hungary. Data for the countries in UNCTAD's "South-East Europe and the Commonwealth of Independent States" category are included in the developing country totals for 2004, but data for these countries are not available by sector and industry for 1990.

SOURCE: Nathan Associates, based on UNCTAD, *World Investment Report 2006*, Annex Table A.1.2.

manufacturing industries while gaining in others. This underlines the fact that developing countries do not have an across-the-board competitive advantage in attracting FDI to manufacturing—despite their supplies of low-cost labor.

Expanding opportunities in services industries. Between 1990 and 2004, the absolute value of developing countries' inward FDI stock in services skyrocketed by well over 700 percent, from $152 billion to nearly $1.3 trillion. And in four of seven major services industries that UNCTAD monitors, developing countries have increased their share of world inward FDI stock during this period. 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 in share of world FDI stock have occurred in construction, retail and wholesale trade, hotels and restaurants, and especially in business services.[2] In some other industries, developing countries increased the value of their inward FDI stock, but still lost shares of world FDI stock: power, gas and water; transport, storage and communications; and finance (banking and insurance services). This suggests that "older" service industries are more attractive in the developed than in the developing economies—at least for now, pending China's continuing liberalization of a broad range of industries and markets.

Appeal of Eastern and Central Europe. The emergence of industries in some former socialist countries as possible investment destinations has reshuffled global FDI inflows somewhat. Recent data for Eastern and Central Europe show that these transition economies—largely absent from world FDI flows in the pre-1990 socialist era—have become appealing destinations for FDI in certain manufacturing industries. Among these are food, beverages and tobacco; wood and wood products; chemicals and chemical products; rubber and plastics; automobiles and transport equipment; electronics and electronic 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, and a host of services, including 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 industry patterns of FDI that the developing world most readily attracts. What then are the broad implications of these

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.

new patterns for FDI's future directions in developing economies?[4]

SERVICES FDI—LONG-TERM GROWTH

The steadily growing allure of services is the single most important trend in foreign direct investment in developing countries. The build-up of services industries as FDI's leading sectoral destination is fundamental, and can only accelerate and intensify. The movement derives partly from the rising importance of services in all economies, but closer examination of the two major categories of services shows other forces are also at play.

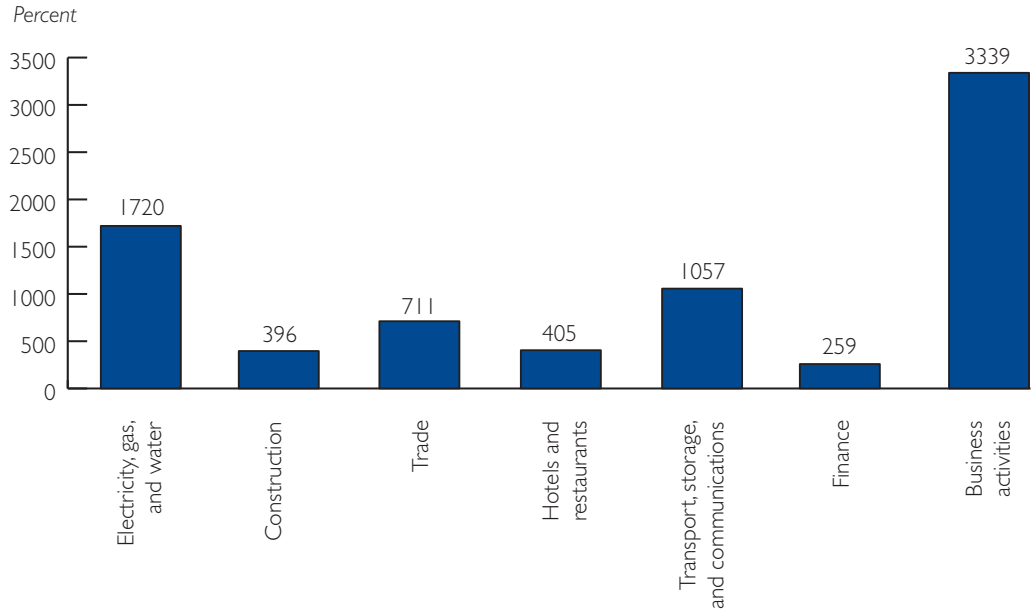
NONTRADABLE SERVICES—MARKET-SEEKING FDI

"Nontradables" are services that must be produced and consumed in the same location. FDI inflows to these services are therefore market-seeking. Public utilities, finance, construction, hotels and restaurants, retail and wholesale trade, and transportation are prime industry destinations for such investment. Inward FDI stock in all these industries has risen rapidly in developing economies since 1990 (Figure 4-2). And the developing world's share of global inward FDI stock in construction, hotels and restaurants, and retail and wholesale trade has grown at rates exceeding those in the developed world (Figure 4-3).

Several factors underlie market-seeking FDI in services. First, FDI in banking, insurance, and transportation traditionally resulted from service providers supporting the foreign operations of existing (manufacturing) clients. This trend may be losing momentum. It appears that providers of nontradables are increasingly investing internationally to reach foreign markets independent

Figure 4-2

Selected Service Industries: Growth in Value of Developing Countries' Stock of Inward FDI, 1990–2004



Note: Includes all countries classified as "developing" by UNCTAD. UNCTAD classifies some countries as developing that the World Bank considers "high income, such as Singapore and South Korea, and classifies some as developed that the World Bank considers "low and middle income," such as Estonia, the Czech Republic, and Hungary. Data for the countries in UNCTAD's "South-Eaast Europe and the commonwealth of Independent States" category are included in the developing country totals for 2004, but data for these countries are not available by sector and industry for 1990.

SOURCE: Nathan Associates, based on UNCTAD, *World Investment Report 2006*, Annex Table A.1.2.

of existing clients, especially as expansion of home markets slows. This should result in more market-seeking FDI possibilities, notably in cross-border M&A deals. High-growth prospects in these new markets will continue to be the principal driver for such FDI, along with liberalization of market entry and the easing of restrictions on foreign ownership and pricing.

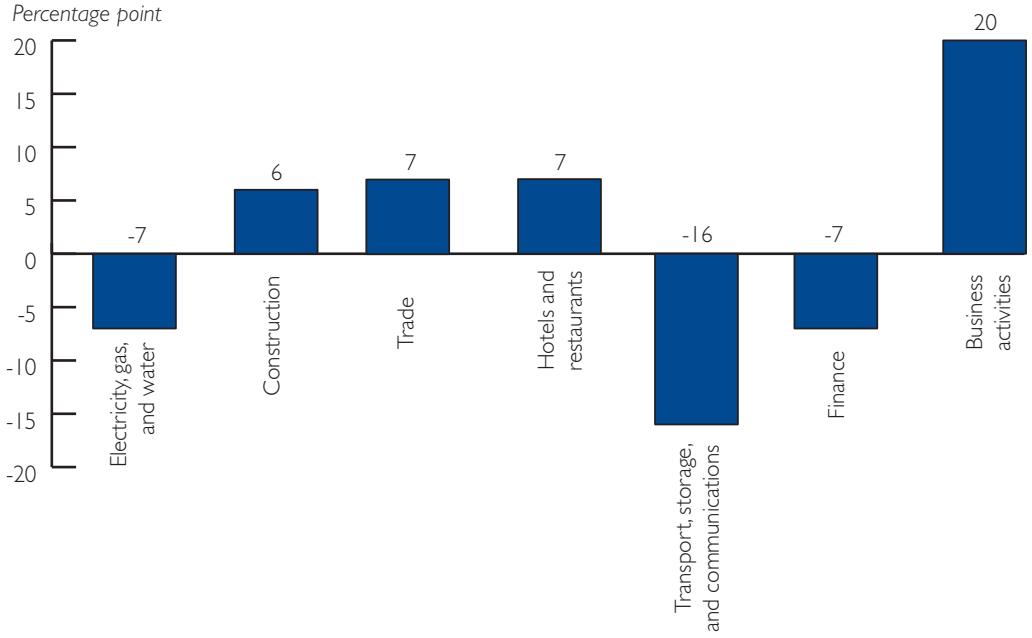
Second, privatization programs will continue to stimulate market-seeking FD in services. In the past, privatization turned many previously out-of-bounds utilities into commercial enterprises. While many major privatizations are now complete, particularly in Eastern and Central Europe and in Latin America, future privatizations may still generate important new opportunities for market-seeking FDI in public utilities, finance, and other nontradable services.

Finally, corporations already engaged in non-tradable services in one market often see advantages in diversifying sources of revenue and profits. Such corporate risk diversification can spur FDI in new host country markets—particularly as those markets become more hospitable to multinationals making equity investments in local services industries.

Market-seeking activities now account for the biggest portion of service-oriented FDI and these inflows can be expected to continue growing as new markets open. China will present the most dramatic opportunities, given its ongoing WTO commitments to free most services for majority foreign ownership. India, where service sector liberalization is gathering momentum, could offer others. The opening of India's multi-brand retailing to FDI, for example, would have

Figure 4-3

Selected Service Industries: Change in Developing Countries' Share of Global Stock of Inward FDI, 1990-2004



Note: Includes all countries classified as "developing" by UNCTAD. UNCTAD classifies some countries as developing that the World Bank considers "high income," such as Singapore and South Korea, and classifies some as developed that the World Bank considers "low and middle income," such as Estonia, the Czech Republic, and Hungary. Data for the countries in UNCTAD's "South-East Europe and the Commonwealth of Independent States" category are included in the developing country totals for 2004, but data for these countries are not available by sector and industry for 1990.

SOURCE: Nathan Associates, based on UNCTAD, *World Investment Report 2006*, Annex Table A.I.2.

tremendous appeal to multinationals. Realizing even part of the potential pipeline of the enormous market-seeking FDI opportunities in these two economies alone may well boost the developing world's future shares of global inward FDI stock in services, including shares in public utilities, finance, and transportation, where developing countries have lagged the global rate of FDI growth.

TRADABLE SERVICES—EFFICIENCY-SEEKING FDI

More services that were once location-bound and nontradable 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.[5]

IT has permitted knowledge to be codified, standardized and digitized, and then sent anywhere at very little cost. Service providers, taking the approach perfected for international manufacturing production networks, now split their products into components and distribute them according to the advantages offered by different locations.[6]

Thus, service-oriented FDI flows can now be efficiency-seeking in at least three ways. First, firms can offshore internal intrafirm services. For example, manufacturers in developed countries create foreign affiliates in low-cost locations to provide back office services to the parent enterprise. Second, independent service providers—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 workers. 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 lowest cost.

UNPARALLELED FUTURE EXPANSION

Efficiency-seeking FDI in services will continue to outstrip and outpace past increases in FDI in efficiency-seeking manufacturing. Services are involved in a vast number of industries in all sectors, while efficiency-seeking in manufacturing affects only that sector. And technology promises to progressively widen possibilities for knowledge management. The exponential growth expected is already evident in business services FDI since 1990 (Figures 4-2 and 4-3).

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

MANUFACTURING FDI—TECHNOLOGY-BASED FUTURE

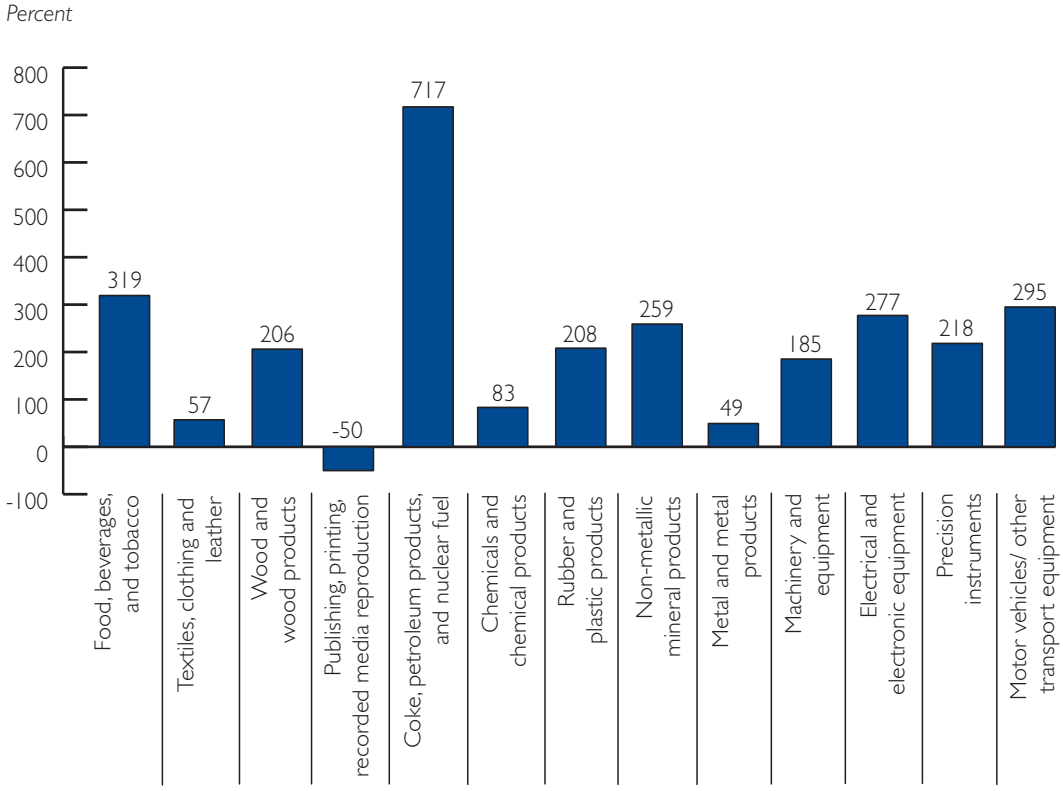
Manufacturing will continue to attract FDI to developing countries but will be less dynamic

Efficiency-seeking FDI for Research and Development

Foreign investment in research and development (R&D) may be one the fastest growing forms of efficiency-seeking FDI in services in the developing world. Critical to technological innovation and therefore to productivity and economic growth, R&D expenditure by business amounted to about $450 billion worldwide in 2002, and is expanding at 4 percent per annum. Multinationals conservatively account for two-thirds of this total, or more than $300 billion per year. While R&D is probably the least internationalized segment of global production networks, the picture is changing. Data are fragmentary, but from 1993 to 2002 the annual R&D expenditure of all foreign affiliates appears to have more than doubled, from $30 billion to $67 billion—and within this total the share of foreign affiliates in developing countries and transition economies skyrocketed from $240 million to nearly $4.6 billion per year. Much of this R&D may be in pharmaceuticals and chemicals, automotives, and IT. And the trend may be intensifying. According to A.T. Kearney's FDI Confidence Index for 2005, nearly 36 percent of global investors plan to increase R&D expenditure in the developing countries of Asia and Eastern Europe. China, India, Poland, and Russia are top locations cited. What attracts this R&D-oriented FDI? Lower R&D costs, the availability and quality of R&D labor, intellectual property protection, the quality of local universities and research centers, and IT and local infrastructure. See also UNCTAD, *World Investment Report 2005: Transnational Corporations and the Internationalization of R&D.*

Figure 4-4

Selected Manufacturing Industries: Growth in Value of Developing Countries' Stock of Inward FDI, 1990–2004



Note: Includes all countries classified as "developing" by UNCTAD. UNCTAD classifies some countries as developing that the World Bank considers "high income," such as Singapore and South Korea, and classifies some as developed that the World Bank considers "low and middle income," such as Estonia, the Czech Republic, and Hungary. Data for the countries in UNCTAD's "South-East Europe and the Commonwealth of Independent States" category are included in the developing country totals for 2004, but data for these countries are not available by sector and industry for 1990.

SOURCE: Nathan Associates, based on UNCTAD, *World Investment Report 2006*, Annex Table A.I.2.

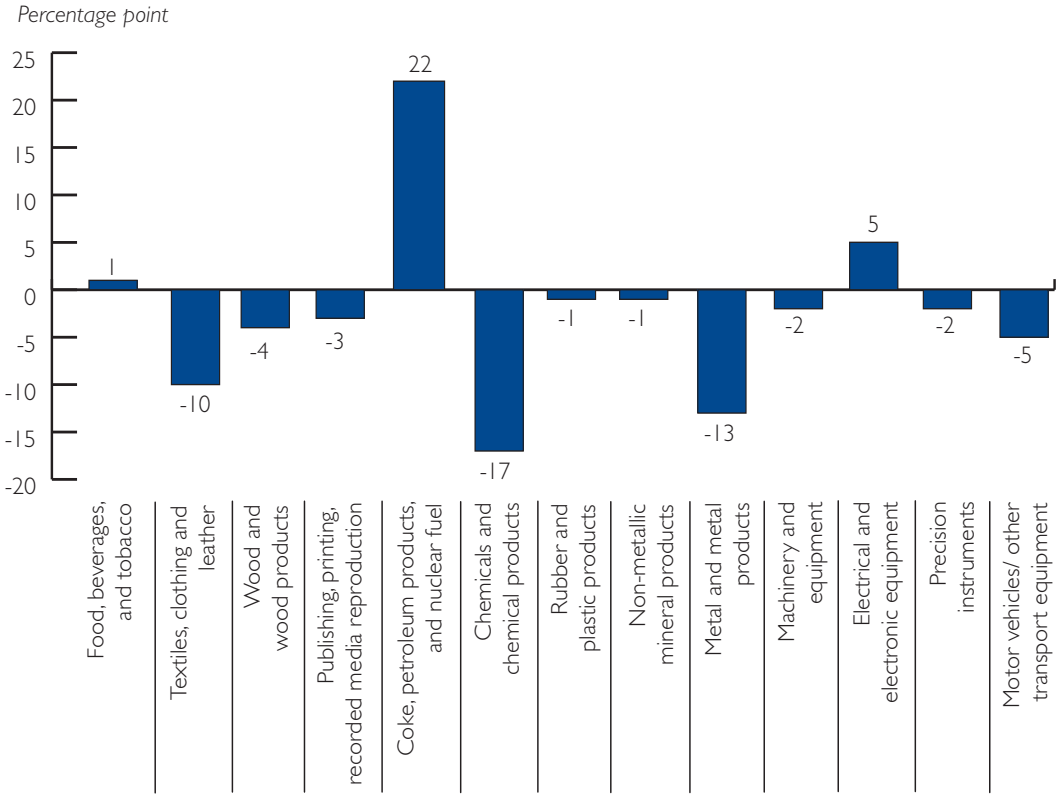
than before. This trend is already evident in a review of industry changes in FDI stock. Between 1990 and 2004, developing countries experienced growth in the value of their stock of inward FDI in all major manufacturing industries (Figure 4-4), but increased their share of stock only in the manufacture of food, beverages, and tobacco; coke and petroleum products; and electrical and electronic equipment. They lost share in other industries: textiles, clothing, and leather; wood and wood products; chemicals and chemical products; rubber and plastics; nonmetallic mineral products; metal and metal products; machinery and equipment; precision instruments; and automobiles and other transport equipment (Figure 4-5).

FUNDAMENTAL CHANGE IN MANUFACTURING

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 also be due even more to a change in the fundamentals of manufacturing.[7] 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

Figure 4-5

Selected Manufacturing Industries: Change in Developing Countries' Share of Global Stock of Inward FDI, 1990-2004



Note: Includes all countries classified as "developing" by UNCTAD. UNCTAD classifies some countries as developing that the World Bank considers "high income," such as Singapore and South Korea, and classifies some as developed that the World Bank considers "low and middle income," such as Estonia, the Czech Republic, and Hungary. Data for the countries in UNCTAD's "South-East Europe and the Commonwealth of Independent States" category are included in the developing country totals for 2004, but data for these countries are not available by sector and industry for 1990.

SOURCE: Nathan Associates, based on UNCTAD, *World Investment Report 2006*, Annex Table A.1.2.

in FDI inward stock in publishing, printing, and reproduction of recorded media.

In such industries, production is increasingly technology-intensive, with capital and knowledge replacing labor. In a modern automobile plant, only a few workers monitor a highly automated production process while others are engaged in purchasing, inventory, logistics, and finance. In this kind of manufacturing, comparative advantage cannot be based on labor cost alone, but must build on other factors: worker skill, worker health, transport costs, logistics efficiency, design, marketing, inventory management. Coupled with the disaggregation of value chains, the consequence is that many manufacturing activities have begun to look like services, reinforcing the shift to services. Accordingly, the appeal of low-cost labor in developing countries is diminishing.

IMPLICATIONS FOR THE "LADDER EFFECT"

Changes in manufacturing have two implications for developing countries. First, 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. 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. Second, as always, host countries along the ladder will need to develop 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, long-term determinants of the physical and sector destinations of FDI in the developing world. But four narrowly focused factors will also drive patterns in FDI over the next decade or so: the phase-out of global textile quotas, the enduring appeal of China as a destination, private investment in infrastructure, 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 countries that had not filled their quotas and which, in effect, enjoyed guaranteed 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 set up operations in Mauritius, Lesotho, the Caribbean, Cambodia, Mongolia and other locations that 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 are now 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 risk significant loss of domestic as well as foreign investment in textile and apparel manufacturing. Countries such as Lesotho (textiles and apparel account for 87 percent of export value), Cambodia (84 percent), Mauritius (57 percent), and the Dominican Republic (51 percent), whose industries have been fueled by FDI and have depended largely on quota restrictions on low-cost Asian producers, could face rapid disinvestment.[8] The full consequences of the end of the MFA are still uncertain, but the major beneficiary will be China. Though not the lowest-cost producer, China is extremely efficient because of massive economies of scale and will be able to dominate the industry thanks to its production volume, reliability, and full-package responsiveness.[9] China could garner a steadily increasing share of textile and apparel industry FDI that would have gone to other locations under the MFA regime.

The 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 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.[10] Bulgaria has reportedly been able to retain FDI in textiles and apparel by upgrading from simple assembly to higher value-added activities.[11] Free trade agreements, such as CAFTA between the United States and the Dominican Republic and Central American

countries or the Morocco–U.S. FTA with its special apparel provisions, could reinforce the attractions of diversification.[12] Ultimately, large-scale, low-cost producers other than China could attract much of future FDI for such manufacturing away from countries like Kenya, Haiti, Jamaica, Mongolia, and Lesotho.[13] Even before quotas were eliminated, production and related investment had begun shifting to such producers, including India, where wages average $0.70 per hour versus $0.92 in China. And Vietnam, where factory wages are reported to be half as much as in manufacturing centers along China's coast, will be a strong competitor for this FDI.[14]

CHINA, THE FDI MAGNET

China has been the developing world's largest recipient of FDI continuously since 1992, and in 2003 was the top FDI destination, thanks to a dip in U.S. receipts. The number of FDI source countries for China is wide and deep, 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, claiming 74 percent of inflows in 2003. Relatively labor-intensive industries (e.g., food processing, clothing, sports goods) make up half of China's FDI,

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, enacted. Many requirements 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 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 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 $72.4 billion in 2005.

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 $13 billion in service sector inward FDI 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 long-term investments. 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 its foreign and domestic companies in overseas markets. This competitiveness has been reinforced (at least for now) by China's decision to revalue its fixed exchange rate against the U.S. dollar only very modestly despite pressure from competitors to do more. 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 export processing zones now operating. Consequently, China will continue to be the developing world's premier investment destination, with a powerful pull for both market-seeking and efficiency-seeking FDI.

Future opportunities for both kinds of FDI will continue to unfold. China's FDI inflows now amount to $56 per capita, far less than 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.

China's success in attracting FDI has provoked some domestic reactions. The All China Federation of Industry and Commerce has called for restrictions on FDI to enhance "national economic security," and domestic business regularly protests the tax treatment accorded foreign investors, whose income is taxed at about one half the rate faced by Chinese firms. Perhaps partly in response, China's National Development and Reform Commission, a key economic policymaking body, has established "quality, rather than quantity" as the guiding principle for future FDI. The new policy is built into the 11th Five Year Program (2006–2010), and gives priority to channeling FDI in higher value-added sectors with advanced technology and R&D components rather than low-cost labor-based manufacturing or assembly. It also discourages imprudent promotion of FDI by local governments, and requires legislation for "supervision of sensitive acquisitions and takeovers to ensure that critical industries and enterprises remain under Chinese control."[15]

Whatever the new policy, the roughly 7 percent annual average rate of increase in FDI that China has enjoyed over the last decade may well extend into the future given the country's assets, opportunities, and robust growth, and assuming a healthy world economy. As noted earlier, growth in China's FDI does not necessarily mean diversion from other locations. In fact, China's new emphasis on the "quality not quantity" of FDI may allow other developing economies to pick up FDI for lower value-added activities as China moves up the technological ladder.

PRIVATE INFRASTRUCTURE DEMAND

Robust long-term economic growth and development requires cost-effective, reliable infrastructure—power, transport, telecommunications and water-sanitation. Everywhere in the developing world, expanding economies and populations are putting enormous pressure on inadequate infrastructure systems and service delivery. Serious infrastructure deficiencies threaten to disrupt economic progress. Faced with fiscal deficits, governments are unable or unwilling to invest in new facilities. In India, for example, "the single most important macro constraint on the Indian economy, holding back its average growth, is the low spending on infrastructure."[16]

One obvious solution is private provision of infrastructure through public–private partnerships. Private infrastructure projects can take a variety of forms, among them nonequity arrangements, but much of the large-scale upgrade and expansion needed in the developing economies requires significant private investment, including FDI by multinationals with expertise in designing, building, and operating power, transportation, telecommunications, and water-sanitation systems. Indian policymakers, for example, have called for roughly $155 billion in FDI for infrastructure over the next ten years, including $55 billion in airports and railways in the next decade, and $75 billion in power and $25 billion in telecommunications in the next five years alone.[17]

Market-seeking FDI has already played a significant role in infrastructure projects in developing countries.[18] In the 1990s investment boomed, going from $13 billion in 1990 to $114 billion in 1997. Privatization of telecoms and electric power utilities through cross-border M&As and concessions in Latin America drove much of this flow, as well as greenfield FDI projects for independent power plants in East Asia. But all regions and all infrastructure sectors received flows. After peaking in 1997, investment declined steadily to $53 billion in 2003.[19] East Asia and Latin America, where the boom occurred, suffered the worst declines. This drop reflected deteriorating conditions for private infrastructure finance, beginning with the Asian Financial Crisis, followed by a severe economic slump in Brazil, further crises in Russia and Argentina, the collapse of world stock markets, and corporate scandals, including that of Enron, a high-profile provider of infrastructure FDI.[20] Under economic stress, the weak design of boom-time projects emerged—impractical pricing provisions, inadequate regulatory structures, inattention to needs for competition, and unsustainable government guarantees. This led to disputes between investors and states, renegotiation or closure of projects, and a depressed market for infrastructure FDI.

In the last two years, however, the trend in private infrastructure investment has again turned positive. In 2005, a total of $96 billion in commitments for infrastructure investments with private participation was reported, with new all-time highs in telecoms ($60 billion), airports ($7.5 billion), and seaports ($5.4 billion). All regions now show recovery from the lows of 2002–2003, with Europe and Central Asia and South Asia setting records. In view of the massive need for infrastructure improvement in developing economies, this cycle of private infrastructure investment will surely gain momentum over the next 10 to 15 years, particularly if lessons about realistic pricing, competition arrangements, regulation, and risk mitigation have been learned. The result will be new and important opportunities for FDI among market-seeking infrastructure multinationals, both in greenfield and cross-border M&As. And because dependable infrastructure is a prerequisite for all foreign investments (Chapter 5 below), infrastructure FDI may be expected to reinforce new FDI flows to all sectors.

SOUTH–SOUTH FDI FLOWS

According to a World Bank survey of FDI inflows and outflows in a sample of developing countries, South-based multinational enterprises became much more active in FDI transactions during the 1990s. South–South flows may now

Table 4-3
Estimated FDI Flows to 35 Developing Countries, by Source, 1995–2003(US$ billion)

	1995	1999	2000	2001	2002	2003
High-income OECD countries	48.1	95.4	93.7	84.8	55.1	59.4
High-income non-OECD	28.2	35.0	22.7	24.8	27.2	22.8
Developing countries (South-South FDI)	14.0	33.1	38.3	49.7	53.0	47.4
Total inflows in developing economies	90.3	163.5	154.7	159.3	135.3	129.6
South-South FDI (percent of total)	15.5	20.2	24.8	31.2	39.2	36.6

Notes: Based on 35 countries that account for 85 percent of FDI flows to developing countries (economies classified as low or middle income by the World Bank).

SOURCE: World Bank, *Global Development Finance 2006,* Volume 1, p. 111.

account for well over one-third of FDI capital received by developing economies (Table 4-3). Though estimates of the annual amount vary considerably, South-South flows have been growing. World Bank data suggest that the share of FDI sourced from developing economies within total FDI received by developing countries has more than doubled since 1995, from 16 percent to 37 percent.[21]

SOURCES AND DESTINATIONS

On the basis of estimated total global FDI outflows, the key sources of South–South FDI may be Russia, China, Brazil, Mexico, Indonesia, and India.[22] Most of this FDI is intraregional; FDI flows within Asia may account for 80 percent of all South–South FDI. Intraregional FDI flows are often directed from a larger, relatively stronger economy to smaller, weaker neighbors. In Africa, for example, intraregional flows are mostly a function of South African multinationals investing throughout the continent. In many countries (e.g., Democratic Republic of the Congo, Botswana, Lesotho, Swaziland) South African FDI represents 50 percent of the total. In Asia, FDI from China and ASEAN probably plays a similarly dominant role in Cambodia, Myanmar, and Laos.

Interregional flows—FDI transactions among Asia, Africa, and Latin America—appear modest, about 6 percent of South–South FDI. Flows from Asia to Africa are estimated to be the largest, well over $1 billion per annum, and from Latin America to Asia the next most important ($0.7 billion).

MOTIVES

Market-seeking may be the most important motivation for South–South FDI.[23] These flows target the manufacture of consumer goods for local or regional sale, or provision of telecommunications, construction, or financial services for host country markets and regions. The Chinese white goods manufacturer Haier, with manufacturing investments in Asia and the Middle East, and the Orascom Group, based in Egypt with foreign affiliates in telecoms and construction in the Middle East and Africa, are examples.

Efficiency-seeking is also an important motivation, particularly among source economies whose labor costs have begun to rise. Textiles and apparel and electrical and electronics industries are frequently associated with this efficiency seeking. In the 1990s, much Chinese investment was driven by the desire to use "quota-rich" African countries as production platforms for apparel destined for the U.S. and EU markets.

Finally, in recent years, natural resource seeking has become an increasingly prominent FDI motive. Chinese and Indian FDI flowing into Africa is now often associated with oil and gas or other extractive industries.[24] And Russia is

reported to be a source of FDI throughout the former Soviet Union, particularly in natural resources.[25]

FUTURE BENEFITS

If economic conditions remain stable and liberalization of trade and investment advances, flows of South–South FDI will likely expand significantly over the next decade. Competition and rising costs in the South's larger home economies, new regional and global opportunities, and the need for oil and other resources will drive these flows. South–South FDI can have a strategic role in the developing world for several reasons. First, South–South flows may have a better effect on production capacity and employment generation than other FDI: South multinationals tend to adopt a greenfield approach to FDI more often than developed country counterparts, and are more oriented to labor-intensive industries.[26]

Second, foreign 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. Analysis suggests that the South's multinationals are more willing to focus on smaller or poorer markets than multinationals from the North (e.g., China and Russia in Mongolia, or India and Turkey in Bangladesh).

Finally, developing country multinationals often have an advantage in developing economies, since their products and processes are often better adapted to local economic and technological conditions. And spillovers are more likely, since the technological gap between these multinationals and host economies is narrower than that between developed country multinationals and these host economies. All of these factors should encourage and intensify South–South FDI flows.[27]

5. ATTRACTING FDI

Developing countries face two fundamental facts about foreign direct investment: (1) it can spur development and (2) competition for it is fierce. No fewer than 200 national investment promotion agencies (IPAs) exist worldwide, and perhaps 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. Confronted with 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: First and foremost, improve the investment climate, then engage in investment promotion.

WHAT FOREIGN INVESTORS WANT—FDI'S DETERMINANTS

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

- ***Natural resource-seeking FDI*** for petroleum and mineral 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 multinational's asset base.

Of course, translating these motives into concrete decisions to invest in a given location depends on many 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, 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.

But, in addition to these commercial-economic factors, 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 economy requires getting the investment climate right. Doing so benefits all investors—foreign and domestic alike. A sound investment climate attracts not only 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"?

An investment climate has three elements: conditions of macroeconomic stability, including institutional and policy predictability; the microeconomic enabling environment; and the infrastructure base. A multinational takes all three into account, although the relative weights given to one element or another in FDI decisions may vary.[6] But because all elements are important, getting the investment climate "right" means making policy and institutional reforms in each area.[7]

For example, a sound investment climate first requires macroeconomic stability and institutional and policy 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; privatization, deregulation, and general recognition of property rights. Liberalization of trade and FDI policy is also part of the reform package.[8] But while macroeconomic stability and institutional predictability are necessary to attract FDI and are achievable through such reforms, many experts now agree that they are not sufficient.

This is why the right investment climate also stresses a proper 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.[9] 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 such as 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. Embracing the principle of nondiscrimination between foreign investors

and domestic investors is particularly important, as is loosening the regulations in FDI regimes.

Taken together, these factors create the competitive markets that give firms incentives and signals to perform efficiently.

Finally, reliable, cost-effective infrastructure is critical to a favorable investment climate. Foreign investors repeatedly identify physical infrastructure—power, transport, water—as the most important determinant of a decision to invest, with cost of utilities running a close second.[10] For example, in a recent analysis of FDI impacts in 14 manufacturing and services industries in Brazil, China, India, and Mexico, multinational executives rated "high quality infrastructure" as the factor most affecting their choice of offshore location, ahead of availability of trained workers, the regulatory environment, and other variables.[11] Technological infrastructure, especially information and communications technology, is also a determinant.[12] Moreover, widespread basic education and public health systems, both essential to workforce development and health, are fundamental to a good investment climate.[13] Together, these elements create a "virtuous circle" in which improvements in infrastructure lead to efficiencies that attract investment, thus expanding the service base that makes infrastructure even more cost-effective for business.

ASSESSING THE CLIMATE

Governments seeking to attract FDI can begin improving the investment climate by assessing conditions. A number of tools are available for the purpose, beginning with the Policy

Business Environment and FDI: Boom or Backlash

A recent forecast of worldwide and emerging market FDI flows highlights the importance of the "business environment" as a determinant of FDI activity. Drawing on data from 82 economies, the Economist Intelligence Unit (EIU) prepared a medium-term forecast (2006-2010) of FDI for developed economies and emerging markets. In the EIU's forecasting model, FDI flows are related to a number of variables: market size, GDP growth, natural resource endowments, distance between countries, labor costs, and the business environment. The latter is an index of values of 91 indicators organized into 10 categories representing various aspects of the "policy, institutional and operating environment." It is designed to represent the "main criteria used by companies to formulate their global business strategies." After running its model to project FDI flows, EIU noted that its results were particularly sensitive to variations in the business environment. This variable was then used to construct alternative FDI "boom" and "backlash" scenarios around the baseline forecast. The boom scenario, which assumes that all countries' quality of business environment scores are 10 percent higher than the values actually forecast, produces a *45 percent increase* in FDI flows for emerging markets. In the backlash scenario, values for an array of business environment indicators are lowered to represent more restrictive FDI polices and rising protectionism. The result? A 19 percent drop in FDI in emerging markets.

SOURCE: EIU, *World Investment Prospects to 2010: Boom or Backlash?* (New York: EIU, 2006) p. 44 and 63.

Exhibit 5-1
Selected Investment Scoreboards

Investment Compass (UNCTAD). Based on macro/microeconomic data supplemented by surveys, the Investment Compass covers regulatory frameworks, public governance, human capital, raw materials, infrastructure, operating costs, market size, and macroeconomic performance of 55 mostly poorer countries in Africa, Asia, and Latin America. Latest survey data are from 2004.

Business Environment and Enterprise Performance Survey (World Bank and EBRD). This survey of national enterprises in 27 transition countries covers business regulation, competition and concentration, corruption, influence and lobbying, infrastructure, labor market, rule of law, financial system. Latest survey data are from 2002.

Doing Business (World Bank). Drawing on local experts, this compendium covers starting a business, dealing with licenses, employing workers, registering property, getting credit, protecting investors, paying taxes, trading across borders, enforcing contracts, and closing a business in 175 countries. Latest survey data are from 2006. Available online at www.doingbusiness.org.

Global Competitiveness Index (World Economic Forum). An aggregate measure of the investment climate, GCI organizes 12 "pillars of competitiveness" into three categories: basic requirements, efficiency enhancers, and innovation factors. The most recent edition covers 125 countries. By 2007 the index is expected to cover at least 135. The index and other investment-related information are available at http://www.weforum.org/en/index.htm.

Index of Economic Freedom (Heritage Foundation; Wall Street Journal) Primarily an assessment of regulatory information, the index covers trade, fiscal burdens, government intervention, monetary policy, foreign investment, banking, wages and prices, property rights, regulation, and informal markets for 161 countries. Latest survey data are from 2006.

FDI Confidence Index (A.T. Kearney). Covering 68 countries, this index is based on a survey of foreign investors that discerns the investment intentions of companies. Latest survey data are from 2005.

Enterprise Surveys (World Bank). Developed with the IFC, this database contains investment climate data on 77 countries based on surveys of nearly 41,000 firms. The organization of 150 indicators into 13 topics permits customized investment climate analysis, including cross-country benchmarking or comparison of indicators by types of firms (sorted by size, sector, exporter vs. non-exporter, foreign vs. domestic). The World Bank uses the data from the surveys to prepare Investment Climate Assessments of selected developing countries. The database is accessible at http://www.enterprisesurveys.org/.

SOURCE: Nathan Associates based on OECD, Investment Committee, Mobilising Investment for Development: Role of ODA (Annex 2, Table 1), adjusted to reflect revision of WEF index, updates to other indices and addition of Enterprise Surveys.

Framework for Investment (PFI) recently finalized by the Organisation for Economic Co-operation and Development (OECD).[14]

Formulated through a consultative process involving 60 OECD and non-OECD economies, PFI is intended to help governments improve investment climates in order to mobilize private investment and enhance its development benefits, especially for the poor. PFI consists of ten mutually reinforcing checklists of questions to assist policymakers as they assess investment climates and implement reform. The checklists may be adapted to a range of situations, and the questions are comprehensive and can help in identifying priorities, framing policies, and monitoring and evaluating progress in creating environments attractive to all investors—foreign and domestic, small and large. The checklists focus on ten policy domains determined through the OECD consultations to have the strongest impact on the investment environment: investment policy; investment promotion and facilitation; trade policy; competition policy; tax policy; corporate governance; responsible business conduct; human resource development; infrastructure and financial sector development; and public governance. Finally, the checklists are complemented by extensive annotations, links to other resources, and examples and descriptions of best practices in investment climate reform.

Other tools for investment climate assessment available to investors and policymakers range from highly aggregated indexes to very narrow country- or industry-specific analyses of institutional corruption and other variables affecting business performance (Exhibit 5-1).[15]

Several organizations offer comprehensive country-specific investment climate surveys. The Enterprise Benchmarking Program of the World Bank Group's Multilateral Investment Guarantee Agency (MIGA) helps measure a country's ability to compete with other locations for FDI. It provides data to evaluate a country's competitiveness by sector, is useful to investors in organizing site selection research, and provides investment promotion bodies and policymakers insight on the quality of business conditions. UNCTAD provides country-level investment policy reviews that help policymakers and investors understand and improve investment climates. Both initiatives continue to expand their country coverage.[16]

IMPROVING THE CLIMATE

Creating the right investment climate is a perpetual process. No country's macroeconomic conditions, microeconomic factors, and infrastructure systems are perfect, and technological progress constantly poses new opportunities and requirements for reform. Many governments, having embraced the principle that the investment climate is a foundation for economic growth and development and a prerequisite for attracting FDI, are pursuing reforms (Table 5-1). Leaving aside the broad reforms necessary for

Table 5-1
Changes in National Investment Regimes, 1992-2005

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Number of countries that introduced changes	43	57	49	64	65	76	60	63	69	71	70	82	102	93
Number of changes	77	100	110	112	114	150	145	139	150	207	246	242	270	205
More favorable to FDI	77	99	108	106	98	134	136	130	147	193	234	218	234	164
Less favorable to FDI	0	1	2	6	16	16	9	9	3	14	12	24	36	41

Notes: Changes favorable to FDI aim to strengthen market functioning and increase incentives; changes less favorable aim to increase control and reduce incentives.

SOURCE: UNCTAD database on national laws and regulations in *World Investment Report 2006*, Table I.11.

Exhibit 5-2

Selected Investment Climate Reforms in Developing Countries by Doing Business Area, 2005-2006

Starting a Business			
Made registration an administrative (non-regulatory) process *Antigua and Barbuda, Czech Republic, Macedonia, Uganda*	Created "one-stop shops" for company registration *Burkina Faso, Croatia, El Salvador, Guatemala, Lithuania, others*	Abolished or reduced minimum capital requirement *China, Georgia, Laos, Madagascar, Micronesia, Morocco*	Simplified tax registration *Armenia, Benin, Bulgaria, India, Lesotho, Lithuania, Tanzania, Uruguay*
Dealing with Licenses			
Reduced number of licenses and permits *Armenia, Georgia, Kenya, Latvia, Moldova, Ukraine*	Introduced statutory time limits for issuing a license *Cambodia, Guatemala, Mali, Ukraine, Vietnam*	Standardized application documents *Georgia, Romania*	Computerized licensing process *Moldova*
Employing Workers			
Made fixed term contracts more flexible *Romania, Vietnam*	Decreased mandatory notice period for dismissal or decreased severance pay *Argentina, Georgia, Macedonia*	Reduced work hour restrictions or over time cost *Georgia, Lithuania*	Removed procedural requirements for redundancy *Georgia*
Getting Credit			
Introduced or revised law for credit bureaus *Algeria, Dominican Republic, El Salvador, Thailand, others*	Established new credit registry *Bulgaria, China, Czech Republic, Georgia, Mauritius, others*	Made enforcement of collateral out of court possible *Armenia, India, Kyrgyz Republic, Peru, Serbia*	Established collateral registry *Azerbaijan, Lao PDR, Peru*
Registering Property			
Decreased taxes or fees *Bosnia and Herzegovina, Ghana, Kyrgyz Republic, Nicaragua, others*	Sped procedures in the registry *Botswana, Croatia, El Salvador, Mali, Nigeria*	Computerized registry and/or made online procedures possible *Croatia, El Salvador, Guatemala*	Combined and eliminated procedures *Armenia, Côte d'Ivoire, Nigeria*
Enforcing Contracts			
Introduced or expanded scope of specialized courts *Burundi, Chad, Gambia, Georgia, Guyana, Nigeria, Peru, Rwanda*	Modified procedural rules or adopted new ones *Brazil, Burundi, Estonia, Gambia, Georgia, Macedonia, Nigeria*	Introduced out-of-court enforcement of small or uncontested claims *Croatia*	Reduced backlog in lower courts *Dominican Republic, Macedonia*

Protecting Investors			
Increased disclosure requirements *Mexico, Peru, Poland, Romania*	Opened company books for shareholder inspection *China, Tunisia*	Made it easier to sue directors *India, Mexico, Tanzania*	Centralized financial market regulation in one agency *Colombia*
Paying Taxes			
Reduced profit tax rates *Albania, Egypt, Guinea-Bissau, Lesotho, Mexico, Pakistan, others*	Reduced number of taxes *Belarus, Egypt, Ghana, Lithuania, Russia, Yemen*	Introduced value added tax *Bosnia and Herzegovina, India*	Introduced electronic filing *Bulgaria, Latvia*
Trading Across Borders			
Introduced customs administration reforms *Cambodia, Georgia, Jordan, Kenya, Nigeria, Pakistan, Romania, Syria*	Improved infrastructure and interagency cooperation at ports *China, Colombia, Jordan, Kenya, Nigeria, Togo*	Applied risk management techniques *China, Colombia, Ghana, India, Jamaica, Kenya, Nigeria, others*	Introduced or improved EDI systems *China, Colombia, Ghana, Jamaica, Kenya, Nigeria, Pakistan, others*
Closing a Business			
Strengthened creditors' powers *Romania, Slovakia*	Introduced bankruptcy law *Burundi, Micronesia*	Allowed pre-insolvency proceedings; made reorganization more attractive *Slovakia*	Improved supervision of bankruptcy administrators *Chile, Latvia, Serbia, Slovakia*

SOURCE: World Bank, *Doing Business in 2007*.

macroeconomic stability and institutional and policy predictability, governments in developing and developed countries alike tend to concentrate on two kinds of efforts to improve the investment climate.

First, they seek to lower costs, risks, and barriers to competition through pragmatic, across-the-board microeconomic reforms. The content of such reforms will vary according to country conditions, but normally pertains to taxes, property rights, and business approval procedures (Exhibit 5-2). Such reforms may be general or sector-specific, and may require cooperation among national, provincial, and municipal governments. Some governments may introduce or upgrade special investment regimes embodying reform to establish an attractive subclimate for FDI-based firms. (These intermediate measures are discussed below).

Second, they enter into international or regional trade or investment accords that can 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.

Ultimately, governments must make formal changes in laws and policies. And as they put reformed laws and policies into practice, they must ensure credibility and foster public trust and legitimacy. In this, there are no one-size-fits-all solutions, and country conditions matter. But some important lessons about reforming investment climates have been learned,[17] and one of the most basic is that getting the reform process right is just as important as making sure that the reform content is sound.

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 countries. 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, but also 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 M&As), or closure of sectors to FDI (Exhibit 5-3). None of these regimes is fail-safe, and many are a gamble even under the best of circumstances.[18] Nevertheless, they are popular among governments, who continually modify them to attract FDI. 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

Exhibit 5-3
Regulatory Measures and Incentives in Foreign Investment Regimes

Screening of admission and establishment may be regulatory or channeling. Certain sectors, industries, or activities may be closed to FDI; minimum capital requirements may be imposed, or modes of entry may be restricted. Incentives are in the form of admission to privatization bidding procedures and establishment of special zones for FDI, with legislation distinct from that governing the rest of the country.

Performance requirements may be regulatory or channeling. Such requirements may cover local content, minimum export shares, trade balancing, and technology transfer; or set standards for local equity participation, employment, and/or R&D. These requirements are meant to maximize linkages from FDI projects.

Fiscal incentives include reductions in standard corporate tax rates, tax holidays, reductions in social security contributions, accelerated depreciation allowances, entry exemptions and drawbacks, export tax exemptions, and reduced taxes for expatriates.

Financial incentives include investment grants, subsidized credits, and credit guarantees.

Other incentives include subsidized service fees (e.g., for power, water, telecoms, transportation) and infrastructure; preferential access to government contracts; closure to the market to further entry and guaranteeing of monopoly rights.

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

complicated sequence of approvals and permits 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). 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: simplified paperwork, e-registrations and virtual interagency networks, and one-stop shops. Though useful, these solutions are not necessarily automatic or complete. For example, the success of one-stop shops is a function of clearly defining mandates and lines of authority to

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. On the basis of its access to markets under the Lome Convention, peaceful multicultural social relations, very high rate of multilingual literacy, 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.

expedite approvals. Otherwise the approval process again becomes bureaucratic and inefficient.[19] In short, strategic, carefully planned streamlining of the administrative framework for investment can benefit foreign and domestic investors, but only as an interim measure until administrative barriers can be removed through full-scale reform and liberalization of the public sector.[20]

EXPORT PROCESSING ZONES

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

Export processing zones (EPZ) have been particularly popular.[21] More than 3,000 exist in 116 countries and employ 43 million workers, mostly women.[22] 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 been built around 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 these 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 5-4).[23]

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.[24]

INCENTIVES

Most developing and developed countries alike provide incentives for FDI. The most common are fiscal—tax holidays, special tax reductions and the like.[25] Others include grants and subsidies and construction of special infrastructure. 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. For example, incentives offered automobile manufacturers in Central Europe amounted to more than $200,000 for each job eventually created.[26] 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.[27] But many multinationals rate a stable and predictable tax regime as more critical.[28] All things being equal, tax incentives may marginally affect location decisions for efficiency-seeking, export-oriented FDI projects.[29] Their influence on market-seeking FDI may be even less significant.

Exhibit 5-4

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; or
- *Nonactionable* 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 government transferring funds directly to exporters, providing goods and services other than infrastructure, and reducing or eliminating taxes. Tax breaks for exporting firms, including duty exemptions on imported machinery used to produce goods for exports—measures common in EPZs—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 and consult with the Committee on Subsidies and Countervailing Measures to determine whether an extension is justified. More than 24 requested 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, Cambodia, Central African Republic, Chad, Democratic Republic of the Congo, Djibouti, Gambia, Guinea, Guinea-Bissau, Haiti, Lesotho, Madagascar, Malawi, Maldives, Mali, Mauritania, Mozambique, Myanmar, Nepal, Niger, Rwanda, Senegal, Sierra Leone, Solomon Islands, Tanzania, Togo, Uganda, Zambia.

Certain Developing Countries (as long as GNP per capita does not exceed $1,000 for three consecutive years, at constant 1990 dollars). Bolivia, Cameroon, Congo, Cote d'Ivoire, Dominican Republic, Egypt, Ghana, Guatemala, Guyana, India, Indonesia, Kenya, Morocco, Nicaragua, Nigeria, Pakistan, Philippines, Senegal, Sri Lanka, Zimbabwe.

Developing and least developed countries seeking to join the WTO may meet the qualifications for exemption, but current members may ask applicants to modify or eliminate export subsidy programs. For example, Cambodia, an LDC, agreed to modify or eliminate a program that provided exemptions on import duties to certain investors.

SOURCES: 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. WTO Agreement on Subsidies and Countervailing Measures, and WTO Decision on Implementation-related Issues and Concerns. www.wto.org, accessed November 30, 2006. WTO. *Report of the Working Party on the Accession of Cambodia*. August 15, 2003, WT/ACC/KHM/21.

Where 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."[30]

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. The investment promotion function may be particularly important for the least developed countries.[31] Investment promotion took root in developing countries after the debt crisis of the 1980s and acceptance of the notion of "Marketing a Country."[32] 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. As of 2006, the World Association of Investment Promotion Agencies (WAIPA) had 204 member agencies, about 75 percent from developing countries.

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.[33] IPA boards are composed of public and private sector representatives, including representatives of training and educational institutions and business associations. IPA staff, who may not necessarily be civil servants, may be paid higher salaries than 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 5-2). 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 fee-for-services as contrary to their marketing role. According to data from 2000, annual budgets for the IPAs of least developed countries averaged $285,000; of economies in transition,

Table 5-2
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 based on UNCTAD data.

$700,000; and of other developing countries, $1.5 million. The budgets of banner IPAs run higher: the Economic Development Board of Singapore, $45 million; the Industrial Development Agency of Ireland, $40 million; CINDE of Costa Rica, $11 million; and MEDIA (now MIDA) of Mauritius, $3 million.[34]

IPAs tend to concentrate on the following types of activities:[35]

- ***Image building.*** Using public relations and advertising techniques, IPAs strive to convey a positive image of their country to international investors and the business community worldwide. Their primary tools are the Internet, especially their own websites.
- ***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

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 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.

services in this phase involve one-stop shops. Services in the operational phase involve monitoring to ensure minimal red-tape in renewing licenses and permits, and that the FDI project has a positive experience under host-country policies and conditions. Such "after-care" servicing is now especially important in retaining or expanding FDI projects, and is a cost-effective form of promotion: in some countries more than 50 percent of FDI is generated from existing investors.[36]

- ***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 function much differently than they did 15 years ago. 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 by country and agency, but for IPAs as a group, the answer may be yes. Recent surveys of 58 agencies yielded interesting insights.[37] 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 development. In countries with a poor investment climate, promotion may be counterproductive. Third, the most fruitful IPA function 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 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, as follows.

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, as noted in Chapter 2. The export capabilities of a developing country often depend heavily on improving productivity through investment, and efficiency-seeking FDI has proven effective in linking local firms in a host country economy into global production networks. 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 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 local populations. Policy advocacy is likely to become more important and require larger budget allocations (Table 5-2). A useful approach to advocacy could be modeled on "The Climate for Foreign Investment in Sweden," the annual report of Invest in Sweden (ISA). The report reviews the country's competitiveness in light of FDI trends, and provides a systematic framework that underscores policy reform needs from the perspective of FDI.[38]

"Picking winners" and targeting investors. The term "picking winners" pertains to national investment promotion policies that target subsectors for FDI, such as financial services software, medical instruments, and agricultural-bloodstock services. The research findings on investment generation cited earlier challenge the wisdom of these policies, but supporters claim that such targeting may have been part of successful development strategies in Ireland, Singapore, Mauritius, Costa Rica, Czech Republic, and Malaysia. After establishing a broadly favorable investment climate, the governments of these countries often targeted sectors and worked with IPAs to create competitive advantages in the 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 FDI targets. With the legendary successes of Ireland IDA or Mauritius MIDA before them, more and 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 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.[39] 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 foreign affiliate buyers and local suppliers initially saw in dealing with each other.[40]

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: invest-

6. INTERNATIONAL AGREEMENTS AND INSTITUTIONS FOR FDI

Open markets, predictability, and rule of law contribute 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 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, and are negotiating more and more of these agreements among themselves. 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 these economies.

INTERNATIONAL INVESTMENT ACCORDS

In 2002, the United Nations hosted a conference in Monterrey, Mexico on financing development. Fifty 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 reached broad agreement on a number of issues. The resulting statement, the Monterrey Consensus on Financing for Development, acknowledges that developing countries must mobilize domestic financial resources for development. It also notes, however, that such resources will fall short of what is needed and that flows of private international capital, particularly FDI, are critical to development.[1] Although significant for the consensus it represents, the statement is hortatory and nonbinding. No comprehensive agreement liberalizes and governs FDI in the way that the WTO's 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.[2] 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 in force skyrocketed, and by the end of 2005 nearly 2,500 BITs had been signed.[3] Most BITs are concluded between developed and developing countries, but an increasing share (27 percent) is between developing countries. At least 176 countries and territories have concluded such treaties.[4]

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.[5] Developing countries negotiate BITs to help provide a favorable climate for foreign investment.

These treaties contain very few specific commitments to development. Their value to development 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.

Provisions of the U.S. Model BIT

Each party must 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").

Limited exceptions are as stipulated in treaty annexes.

Expropriation has clear limits; investors are entitled to fair compensation and have the right to transfer funds out of the country.

Trade-distorting practices, such as performance requirements, including the use of local content or a requirement to export a certain share of production, are prohibited.

In a dispute with a foreign government investors have the right to international arbitration, and are not obliged to use the government's domestic courts.

Firms may hire top managers regardless of nationality.

States are prohibited from lowering environmental and labor protections to promote investment.

To become effective on the U.S. side, the treaty requires approval by two-thirds of the U.S. Senate.

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, greater economies of scale can be achieved in production of goods and services, and investors have 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.[6] 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 a great number of FTAs or RIAs containing of rules on investment have been concluded.

For example, the North American Free Trade Agreement (1994), FTAs between the United States and Chile, Singapore, Oman, Morocco and Australia, and others recently concluded with the Dominican Republic and Central American countries, as well as with Peru and

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, Mozambique, Nigeria, 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 Korea, 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.

with Colombia, all contain provisions similar to BIT obligations and often contain 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.[8] 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.[9] 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 world.

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 intended 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 is considered an investment by most modern investment agreements.
- ***Agreement on Subsidies and Countervailing Measures*** limits or bans a number of investment incentive schemes, such as 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 Doha ministerial of 2001 members agreed to begin negotiating a multilateral framework on investment after the Cancun ministerial of September 2003. The WGTI began preparatory work for such negotiations (Exhibit 6-1) but was unable to reach consensus at the Cancun ministerial. In August 2004, ministers announced that the "Doha Development Agenda" would contain no negotiations on investment.[10]

The question of whether to negotiate a full package of rules on investment is contentious. After a failed two-year effort to conclude a Multilateral Agreement on Investment, OECD members abandoned such negotiations in

1998.[11] But many advocates, particularly among developed countries, continue to argue that by reducing host-country investment restrictions and better protecting investors' rights an agreement will give rise to larger, more sustained flows of FDI to developing countries. Governments, however, cannot guarantee private investment flows. And without such a guarantee many developing countries are reluctant to accept limits on investment policies that promote their own perceived economic interests.

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.

INVESTMENT ACCORDS—IN PRACTICE, IN PROSPECT

Bilateral agreements have proliferated but perhaps with limited effect. Multilateralism in investment agreements seems as unlikely as ever. But regional trade agreements and dispute settlement 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.

Little benefit from BITs. The proliferation of BITs suggests that they satisfy the demands of the states concluding them. Firms in developed countries receive additional protections if they choose to invest in a BIT partner's territory, but do BITs attract foreign investment?[12] 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 those for 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.

FTA/RIA boost for FDI. BITs alone seem to have a negligible effect on investment flows, but strengthening investor protections and reducing trade barriers does 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

Exhibit 6-1
Issues for the WTO Working Group on Trade and Investment

The Doha Ministerial Declaration of November 2001 tasked the Working Group on Trade and Investment (WGTI) with examining issues shaping the agenda of potential WTO investment negotiations, to begin in 2003. Although such negotiations never materialized, these issues included:

- ***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 or on how to administer rules and regulations. Developing countries have expressed concern over 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 multinational corporations transfer technology and how host economies absorb it.
- ***Nondiscrimination 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 agree that the kind of general and security exceptions usually found in WTO agreements should apply to any future investment agreement. They also tend to agree that these conditions must be clear to ensure that arbitrary or unjustifiable discrimination is not permitted.

climate.[16] In any event, the general experience of FTAs and RIAs suggests that (1) such accords encourage adoption of international standards and best practices, and (2) despite claims to the contrary, do not tend to divert FDI from nonparticipating to participating developing countries.[17]

WTO impacts through TRIMs and TRIPS. 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 RIAs, contain dispute settlement provisions. As BITs have proliferated, so have dispute settlement cases. Individual investors have brought

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 jobs and impart the technology and managerial know-how of foreign affiliates to the domestic economy. Linkage building is most effective when 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, and are to be eliminated by WTO members. Least developed countries have until 2020 to accomplish this phase-out.

the vast majority of these cases against states using international arbitration procedures. UNCTAD estimates that at the end of 2005, the number of cases brought under bilateral and plurilateral agreements totaled 229.[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 agreements are likely to be more regional and more attentive to investment promotion and dispute settlement.

Regionalism. In the near to medium term, the drive for investment liberalization and rule-making is likely to be channeled through regional agreements. First of all, the suspension of the Doha Round threatens to retard multilateral economic liberalization in general. In the late 1990s, developed countries had made no progress on the multilateral agreement on investment, and in 2004 developing countries thwarted the negotiation of comprehensive investment-related disciplines within the Doha Development Agenda. With prospects for a multilateral framework seriously 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 future FTA and RIA negotiations.[19]

Investment Promotion. 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.

Dispute Settlement. 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

Several international and regional institutions are seeking to facilitate FDI flows to foster development. They aim 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) stimulate FDI flows by mitigating the elevated political and economic risks in many developing countries.

BUILDING CAPACITY TO PROMOTE INVESTMENT

International public sector institutions that build capacity in FDI promotion are varied in form and structure (Exhibit 6-2). 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 ever. Comparisons of investment promotion and industrial marketing suggested that countries could market themselves to multinational foreign direct investors just as large-scale suppliers

Exhibit 6-2
International Institutions Building Investment Promotion Capacity

Foreign Investment Advisory Service. Founded in 1985 as a joint service of the World Bank and IFC, FIAS advises governments on improving the climate for domestic and foreign investment. Its conducts investment climate diagnostics, designs investment laws and IPAs, analyzes administrative barriers, and studies industry competitiveness.

Tools and Products. Investment climate assessments; recommendations for legislative reforms; "regulatory guillotine approach" for reform of licenses and permits; Administrative Barriers Reform Toolkit; various business enabling environment toolkits.

International Chamber of Commerce. Based in Paris and founded in 1919, the ICC is a forum for international businesses. Members are multinational companies and individuals in 130 countries. The ICC organizes conferences, publishes position papers, and helps resolve commercial disputes.

Tools and Products. Business policy statements for governments and international institutions; investor surveys with UNCTAD; international commercial arbitration.

International Finance Corporation. Established in 1956 as an arm of the World Bank group, the IFC is the largest public multilateral source of loan and equity financing for private sector projects in developing countries. It provides equity and other forms of financing for investors and entrepreneurs and its SME Department, operated with the World Bank, provides technical assistance for business environment reforms in developing and transition countries.

Tools and Products. Project finance and syndication (loans, equity capital); technical assistance with domestic market policy; programs to link small and medium enterprises to IFC investments; business environment reform toolkits and manuals (business licensing, business registration, and alternative dispute resolution).

Multilateral Investment Guarantee Agency. A member of the World Bank Group, MIGA was established in 1988 to promote FDI in developing countries by providing risk insurance to investors. MIGA also provides capacity building assistance for investment promotion, dispute mediation services, and information on FDI.

Tools and Products. Investment guarantees; Investment Promotion Toolkit; Enterprise Benchmarking Program; online FDI services, including the fdi.net information clearinghouse; FDI Promotion Center (online resource in English, Russian Arabic, and Serbian); Political Risk Insurance Center (online resource for risk management).

Organisation for Economic Co-operation and Development. Based in Paris and established in 1961 from an organization set up to administer the Marshall Aid Plan, the OECD members include European countries, Japan, United States, Mexico, Canada, Australia, and New Zealand. It promotes liberalization, best practices, and corporate governance on FDI through conferences, publications, and studies.

Tools and Products. Nonbinding codes of conduct for multinational corporations; Policy Framework for Investment; "checklists" on best practices in attracting and governing FDI; Investment Policy Reviews; Regulatory Impact Assessment best practices.

United Nations Conference on Trade and Development. UNCTAD was founded in the U.N. in 1964 and is based in Geneva. An intergovernmental forum, it promotes integration of developing countries into world economy. UNCTAD provides technical assistance, research, policy analysis, seminars, and workshops for capacity building and technical assistance.

Tools and Products. World Investment Report; Investment Compass; Country Investment Policy Reviews; best practice cases on technology transfer through FDI.

The ***World Association of Investment Promotion Agencies*** was founded in 1995 as a nongovernmental organization in Geneva. WAIPA is a world forum for exchange of best practices in investment promotion. It promotes cooperation among 200-plus IPAs, including information-gathering and advice on strategies and policies.

Tools and Products. Training workshops customized by region; publications; networking.

marketed goods and services to corporations. In the wake of global recession and declines in FDI flows in the early 2000s, the 2002 Monterrey Consensus acknowledged the importance of FDI and other private international resource flows for development, giving more impetus to public sector efforts to build promotion capacity.

To build capacity, international institutions provide developing countries assistance in implementing liberalizing agreements on investment, training in investment promotion, assessing institutional needs and devising strategic plans, organizing FDI promotion workshops and simulations, and using IT applications to disseminate investment opportunities and market intelligence. They frequently cooperate in delivering these services. For example, the Multilateral Investment Guarantee Agency collaborates with USAID and the World Association of Investment Promotion Agencies (WAIPA), often delivering joint workshops and 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. Its 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 new FDI.net to learn about opportunities for investment 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 11th terrorist attacks have heightened perceptions of risk in emerging country markets. In addition, 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 governance. Such concerns can be partly resolved through negotiations, but several 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—COFACE, 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,*** such as Lloyds of London, provide international risk insurance, often in cooperative underwriting 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 the end of 2005, ICSID had pending 113 cases valued together at about $30 billion. 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 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. More than three-quarters of all developing country inflows go to 20 or so countries; the rest is divided among more than 125 countries. But when measured on a per capita basis, even a little FDI can go a long way in a small economy.

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 end of the Multifibre Arrangement of global quotas that long diverted FDI to poorer developing countries 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, and these sectors still present vast possibilities. But, at the same time, efficiency-seeking activities such as export-oriented business support services are the fastest growing segment, and this expansion will accelerate.

6. The 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

Foreign Direct Investment and the Costa Rica Brand

How did Costa Rica become the top destination for FDI 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. 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. 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. 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.

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 minimal 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 measures 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. 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. They have no doubt played a role in the rise of FDI and will continue to do so.

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

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 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. It should also give priority to reforms that strengthen the links between trade and investment.

2. ***Forging better and stronger linkages 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, and opportunities for private financing of infrastructure are again raising interest among foreign investors. 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,

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 on those that can clearly induce 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 no negative impact on U.S. jobs is likely (as determined by ADS standards), and if 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 category of activity. Please 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.

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 to formulate promotion strategies and visions that mesh with national development strategies, to create systems and procedures to implement those strategies, and to 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 and regional 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 with useful result (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.

- ***Monitoring and 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 renewed growth in the global economy, FDI inflows to the developing world have indeed risen 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 responsiblities—for making the most of FDI. The policy 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 2006*, p. 9. (Referred to hereafter as WIR 2006.)

[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] Data on FDI and other capital flows cited in this chapter are reported in World Bank, *Global Development Finance 2006* (referred to hereafter as *GDF 2006*) and the World Bank's Global Development Finance database (for years prior to 1998). *GDF 2006* totals for FDI differ somewhat from data compiled by *WIR 2006*. Orders of magnitude and trends are, however, consistent between World Bank and UNCTAD sources.

[5] 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.

[6] The economy in which the parent enterprise is resident is considered the "home country," and the economy in which the foreign affiliate is resident is considered the "host country."

[7] While UNCTAD and others gather statistics on cross-border M&A flows, no data exist on the annual value of greenfield FDI flows. Hence greenfield FDI is estimated here as a residual after subtracting cross-border M&A from total recorded FDI inflows. But this residual does not encompass greenfield FDI alone: it includes all other FDI flows that follow an initial foreign investment by a parent enterprise, such as reinvested earnings in or intracompany loans to its foreign affiliate. Though not precise, these figures demonstrate that cross-border M&A appears to be the dominant FDI flow globally and in developed countries, while greenfield FDI is more important in the developing world.

[8] UNCTAD, *WIR 2006*, p.17.

[9] *Ibid.*, pp. 16–21.

[10] World Bank, *GDF 2004*, pp. 86–90.

[11] In addition to volatility arising from economic conditions, 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 have the same effect.

Further, home country tax policies can have an impact on the reinvested earnings component of FDI, as U.S. experience under the Homeland Investment Act of 2004 demonstrates. See Chapter 3, Sources of FDI for Developing Countries and footnote 6.

CHAPTER 2

[1] This typology of FDI flows from the perspective of the enterprise 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] See *WIR 2002*, pp. 154–157.

[3] 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), and the Caribbean Basin Trade Preference Act (CBTPA). The European Union grants preferences through its Everything But Arms (EBA) program. Japan, Canada, and other developed countries offer similar arrangements. Under unilateral preference programs, products originating in developing countries are granted special quota or tariff access. Such programs often restrict certain products of interest to developing country exporters, must be renewed periodically, and can be revoked at any time by the granting country. Two or more trade partners may negotiate an arrangement in which they grant reciprocal 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.

[4] Specialists in the World Bank's Foreign Investment Advisory Services note 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, p. 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.

[5] 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 far less costly Chinese manufacturing facilities, replacing the manufacturing sent on to South or Southeast Asia.

[6] Of course, global production networks and value chains in manufacturing and in services can be set up by equity (FDI) and nonequity 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, 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 preferred.

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

[8] For example, FDI in such extractive industries as mining, quarrying and petroleum is largely resource-seeking, while FDI in automotive manufacturing is likely efficiency-seeking, and in service industries such as finance or electricity, gas, and water, it is probably market-seeking.

[9] Ample empirical research shows how FDI's favorable impact on domestic investment affects capital accumulation. Other external resource inflows (i.e., portfolio equity or debt) to developing countries often fuel higher consumption or growth of foreign exchange reserves, but 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." And, contrary to fears that FDI-financed foreign affiliates borrow heavily from host-country banks and "crowd out" local firms, exacerbating financing constraints, there is evidence that FDI eases 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). 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). Another recent study concludes that FDI is less likely to crowd out and more likely to crowd in domestic investment in developing countries than in developed ones. It finds that research leading to a contrary result may derive from inappropriate pooling of data across developing and developed economies. See Bruce A. Blonigen and Miao Grace Wong, "Inappropriate Pooling of Wealthy and Poor Countries

in Empirical FDI Studies," in *Does Foreign Direct Investment Promote Development?* ed., Theodore H. Moran, Edward M. Graham and Magnus Blomström, Washington DC: Institute for International Economics and Center for Global Development (2005). On the other hand, UNCTAD's *Trade and Development Report 2003: Capital Accumulation, Growth and Structural Change* cites studies that cast doubt on the relationship between FDI and capital accumulation by presenting evidence of crowding out, especially in Latin America. Yet UNCTAD 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.

[10] For the contrary view that FDI may crowd out domestic investment, see, for example, Nagesh Kumar and Jay Prakash Pradhan, "Foreign Direct Investment, Externalities and Economic Growth in Developing Countries: Some Empirical Explorations" in *Multinational and Foreign Investment in Economic Development*, ed., Edward M. Graham, New York: Palgrave Macmillan and International Economics Association (2005).

[11] *GDF 2006*, p. 143 and p. 159.

[12] 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?" in *Does Foreign Direct Investment Promote Development?* ed., Theodore H. Moran, Edward M. Graham and Magnus Blomström, Washington DC: Institute for International Economics and Center for Global Development (2005).

[13] Many empirical studies show positive relationships between FDI and 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 note 9, 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. Well functioning financial markets may be another precondition: see Laura Alfaro, Areendam Chanda, Sebnem Kalemli-Ozcan and Selin Seyek, "How Does Foreign Direct Investment Promote Economic Growth? Exploring the Effects of Financial Markets on Linkages," Harvard Business School Working Paper Number 07-013 (August 2006). 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).

[14] For a note on the view that the full growth benefits of FDI depend on open trade and pro-investment markets, policies and institutions, see Mark J. Melitz, "Comment," in *Does Foreign Direct Investment Promote Development?* ed., Theodore H. Moran, Edward M. Graham and Magnus Blomström, Washington DC: Institute for International Economics and Center for Global Development (2005).

[15] See, for example, Joshua Aizenman and Ilan Noy, "FDI and Trade—Two Way Linkages," NBER Working Paper, No. 11403 (October 2005) for evidence of inter-temporal linkages between FDI and manufacturing trade; and for the food industry, Norbert Wilson, "Linkages amongst Foreign Direct Investment, Trade and Trade Policy: an Economic Analysis with Applications to the Food Sector," a paper presented to the American Agricultural Economics Association meeting, July 2006. For a view of FDI and trade as both substitutes and complements at the product level in the automobile industry, see Bruce A. Blonigen, "In Search of Substitution Between Foreign Production and Inputs," *Journal of International Economics, 53(1)*. For evidence of the complementarity between FDI and trade in Africa, where Chinese and Indian FDI-financed firms are increasing export intensity and diversity of local industry, see Harry G. Broadman, *Africa's Silk Road, China and India's New Economic Frontier (Advance Edition)*, Washington, DC: World Bank (2006).

[16] *WIR 1999*, pp. 246–247.

[17] World Bank, *Global Economic Prospects* 2003, pp. 46–49. The real annual rate of growth in developing county FDI inflows for 1978–2001 is calculated using UNCTAD FDI data, deflated by the U.S. GDP deflator.

[18] For discussion of interaction between FDI and trade, and the role of multinationals in export growth and competitiveness, see *WIR 1999*, pp.229–256; and *WIR 2002*, pp. 151–161. See also UNCTAD's conclusions in WTO Document WT/WGTI/W/8/Add.1, "Implications of the Relationship between Trade and Investment for Development and Economic Growth," pp. 14–16.

[19] For a summary of research and analysis of productivity-inducing effects of FDI, see Theodore H. Moran, *Harnessing Foreign Direct Investment for Development Policies for Developed and Developing Countries*, Washington DC: Center for Global Development (2006), pp. 6-27; Theodore H. Moran, *Parental Supervision: the New Paradigm for Foreign Direct Investment*, Washington DC: Institute for International Economics (2001); and Theodore H. Moran, "How Does FDI Affect Host Country Development? Using Industry Case Studies to Make Reliable Generalizations," in *Does Foreign Direct Investment Promote Development?*

[20] Many studies demonstrate significant productivity improvements among firms receiving FDI. See Jens Arnold and Beata Javorcik, "Gifted Kids or Pushy Parents? Foreign Acquisitions and Plant Performance in Indonesia," World Bank Policy Research Working Paper 3597 (May 2005); and Simeon Djankov and Bernard Hoekman, "Foreign Investment and Productivity Growth in Czech Enterprises," in *Global Integration & Technology Transfer*, ed., Bernard Hoekman and Beata Smarzynska Javorcik, Washington DC: World Bank (2006).

[21] See for example, Beata Smarzynska Javorcik, "Does Foreign Direct Investment Increase the Productivity of Domestic Firm? In Search of Spillovers through Backward Linkages," World Bank Policy Research Paper 2923 (October 2002). Javorcik demonstrates positive vertical technology transfers from FDI-financed foreign affiliates to upstream suppliers in Lithuania, especially among foreign-local joint ventures (but not so with wholly owned foreign affiliates). The study also finds an absence of technology transfer between FDI-financed foreign affiliates supplying downstream local customers. Further evidence of vertical spillovers for Czech and Latvian firms supplying foreign affiliates is presented in Beata Smarzynska Javorcik and Mariana Spatareanu, "Disentangling FDI Spillover Effects: What Do Firm Perceptions Tell Us?" in Moran *et al., Does Foreign Direct Investment Promote Development?* In the same volume, in "Foreign Direct Investment and Externalities: the Case for Public Intervention," Garrick Blalock and Paul Gertler show strong vertical spillovers to upstream suppliers of FDI-financed foreign affiliates in Indonesia, and clear evidence of higher profitability, lower prices, increased entry and increased output in these supplier markets.

[22] Some studies show that technology transfer can take the form of 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). In analyzing Indonesian manufacturing, Robert Lipsey and Frederik Sjöholm demonstrate that horizontal productivity spillovers occur so long as competition and absorptive capacity are sufficient, and the technological gap among firms is not extreme (see "The Impact of Inward FDI on Host Countries, Why Such Different Answers?" in Moran *et al.*). 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, conclude that while FDI boosts productivity in (relatively smaller) own-plant or joint venture operations, domestic firms suffer negative horizontal spillovers—loss of market share —in the presence of FDI in the same industry. Studies cited in notes 20 and 21 by Djankov and Hoekman in the Czech Republic, Javorcik and Spatareanu in the Czech Republic and Latvia, and Javorcik in Lithuania, all fail to find evidence of horizontal spillovers.

[23] Vertical spillovers, for example, may operate more powerfully with partially foreign owned affiliates than with wholly owned ones, which may engage in more limited local sourcing. See Beata S. Javorcik and Mariana Spatareanu, "To Share or Not to Share: Does Local Participation Matter for Spillovers from Foreign Direct Investment?" Rutgers University Working Paper No 2006-001. Also, Susan Feinberg and Michael P. Keane, "Intrafirm Trade of US MNCs: Findings and Implications for Models and Policies Toward Trade and Investment," in Moran *et al.*, conclude that multinationals engaged in intrafirm trade seem more likely to transfer best practices and knowledge than multinationals not so organized.

[24] 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.

[25] 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.

[26] Competitive pressures (lost market share) on local firms that accompany the entry of FDI-based foreign affiliates into an industry may offset the positive technology impacts associated with those affiliates through demonstration effects and labor mobility. This may be one reason that analyses at the industry level fail to find horizontal spillovers. See Javorcik and Mariana Spatareanu, "Disentangling FDI Spillover Effects: What Do Firm Perceptions Tell Us?" in Moran *et al.* At the same time, research in Turkey's manufacturing sector suggests that the presence of foreign affiliates of multinationals may lead domestic firms to increase R&D, a horizontal spillover. See Asim Erdelik, "R&D Activities of Foreign and National Establishments in Turkish Manufacturing", in Moran *et al.*

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

[28] For a description of the improved productivity and performance of service industries associated with FDI, see Harry G. Broadman, ed., *From Disintegration to Reintegration, Eastern Europe and the Former Soviet Union in International Trade*, Washington DC: World Bank (2006), pp. 296–327.

[29] Further, a sharp expansion in commodity exports induced by natural-resource-seeking FDI could lead to a sustained increase in export revenues from extractive industries and a significantly appreciating host country currency. This in turn could lead to "Dutch Disease," wherein currency appreciation renders other exports uncompetitive.

[30] 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.

[31] 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 in foreign affiliates and less skilled workers in local firms, or unemployed workers. 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. Some researchers have found a direct link between FDI and poverty reduction. On study, for example, concluded that in five ASEAN countries 40 percent of FDI's poverty reduction arises indirectly through general economic growth and 60 percent through direct effects, probably labor training and direct employment. See Hossein Jalilian and John Weiss, "Foreign Direct Investment and Poverty in the ASEAN Region," University of Bradford UK and Asian Development Bank Institute (July 2001).

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

[33] See, for example, Robert E. Lipsey and Fredrik Sjöholm, "Foreign Direct Investment, Education and Wages in Indonesian Manufacturing," *Journal of Development Economics*, 73 (2004). Lipsey and Sjöholm demonstrate that for a worker with a given level of education, FDI–based firms tend to pay higher wages. Similarly, Dirk Willem Te Velde and Oliver Morrisey, "Foreign Ownership and Wages: Evidence from Five African Countries," CREDIT Research Paper No. 01/19 (November 2001), found that foreign owned firms paid on average 8 percent–23 percent higher than domestic firms in the same high wage sectors and regions. The higher level of benefits and training offered workers in FDI-based enterprises is emphasized under Miyamoto, in note 25.

[34] 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). For an excellent summary of labor issues and FDI, see Theodore H. Moran, *Harnessing Foreign Direct Investment for Development Policies for Developed and Developing Countries*, Washington DC: Center for Global Development (2006), pp. 58-72.

[35] *WIR 2006*, p. 235.

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

[37] 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).

[38] See OECD, *Environment and the OECD Guidelines for Multinational Enterprises Corporate Tools and Approaches* (2005).

CHAPTER 3

[1] Data for this chapter are from *WIR 2006* except where noted, and are expressed in terms of total "FDI inflows." *WIR 2006* data have been adjusted to conform to the more restrictive definition of developing countries explained in endnote 2.

[2] The discussion that follows adopts the World Bank definition of "developing countries." Under it, only low-income and middle-income countries are included. These consist of 150 economies with per capita Gross National Income (GNI) of $10,725 or less in 2005. This eliminates countries classified as "developing" by the UNCTAD: Singapore, Hong Kong China, Korea, Brunei, Taiwan, Cyprus, Kuwait, Qatar, Saudi Arabia, UAE, Barbados, Bermuda, and Cayman Islands. Similarly, certain economies considered "developed" by UNCTAD (e.g., Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland and Slovakia) are classified as middle income by the World Bank and are included under "developing" countries in this discussion.

[3] Data on GDP and trade growth reported in *GDF 2006*, pp. 16–18.

[4] This discussion of medium term prospects draws on Economist Intelligence Unit, *World Investment Prospects to 2010 Boom or Backlash?* New York: The Economist Group (2006).

[5] *WIR 2006*, pp. 36–37, summarizes FDI prospects for the short-term (2006–2007) and includes regional and sectoral views. Various private surveys of business confidence and investment sentiment for emerging markets are reported there.

[6] The United States generated the world's largest FDI outflows during the 2003–2005 period even though its outflows for 2005 were $-12.7 billion. These negative outflows reflected a massive repatriation of earnings by U.S. multinationals from foreign affiliates under the Homeland Investment Act of 2004. Under certain conditions and for a period of one year, multinationals could repatriate foreign earnings at reduced tax rates. Repatriation of such earnings is equivalent to an offsetting decline in reinvested earnings of foreign affiliates, a component of FDI outflows, thus reducing U.S. outflows. See *WIR 2006*, pp. 88–89. The experience underlines the influence that home country tax policies have on the FDI flows, emphasized in Chapter 1 ("FDI by Financial Component").

[7] See 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

[8] UNCTAD, FDI in Least Developed Countries at a Glance: 2005/2006, UNCTAD/ITE/IIA/2005/7.

[9] This subsection on regional patterns draws on Economist Intelligence Unit, *World Investment Prospects to 2010 Boom or Backlash?* New York: The Economist Group (2006); and on A.T. Kearney, FDI Confidence Index, 2005, at www.atkearney.com/shared_res/pdf/FDICI_2005.pdf.

[10] See *China Daily*, October 6, 2006, online at www.chinadaily.com.cn/bizchina/2006-06/10/content_613598.htm.

[11] See, for example, Busakorn Chantasasawat, K.C. Fung, Hitomi Iizaka and Alan Siu, "Foreign Direct Investment in East Asia and Latin America: Is There a People's Republic of China Effect?, ADB Research Paper Series No. 66, (June 2005); and Charles Kramer, "Asia's Investment Puzzle," *Finance & Development*, Volume 43, Number 2 (June 2006).

[12] See, for example, A.T. Kearney, FDI Confidence Index, 2005, available at www.atkearney.com/shared_res/pdf/FDICI_2005.pdf; and PricewaterhouseCoopers, 9th Annual Global CEO Survey (2006) at /www.pwc.com/extweb/insights.nsf/docid/ AA8C89E30F8ECE3080257093004DB382.

CHAPTER 4

[1] The analysis of inward FDI stock is based on data reported in *WIR 2006*, Annex table A.I.2. 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] Several surveys regularly present forecasts of FDI flows by sector and industry. In addition to the A.T. Kearney FDI Confidence Index and the PricewaterhouseCoopers Annual Global CEO Survey cited earlier, UNCTAD prepares a four-year forecast, *Prospects for Foreign Direct Investment and the Strategies of Transnational Corporations*, on an annual basis, drawing on opinions of experts and investment promotion agencies to project industry FDI flows. See www.unctad.org/fdiprospects.

[5] *WIR 2004*, p. 150, for a description of the wide array of services exported by developing countries.

[6] *Ibid*. pp. 95–96.

[7] *Ibid*. pp. 29–31.

[8] For a description of the impact of MFA's closure on Lesotho's textile and apparel sector, see *WIR 2006*, p.191. The U.S. dollar's sharp depreciation coincided with the end of the MFA regime also negatively effected Lesotho's textile and apparel enterprises. See Michael Wines, "Dollar's Fall Silences Africa's Garment Factories," *New York Times*, March 12, 2005.

[9] The power of China's textile and apparel enterprises is evidenced by the surge of Chinese textile and apparel exports to the United States after the lifting of MFA—a reported 46 percent increase in the first eight months of 2005 before U.S. imposition of safeguard restrictions to limit growth. See David Kay Johnson and Keith Bradsher, "China and US Expected to Reach Deal on Textiles," *New York Times*, November 5, 2005.

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

[11] *WIR 2006*, p. 80.

[12] 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., Andean Trade Preference and Drug Eradication Act, and African Growth and Opportunity Act). These 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 nonbeneficiary countries, or present other special advantages (e.g., just-in-time capability).

[13] UNCTAD, *TNC's and the Removal of Textiles and Clothing Quotas*, UCTAD/ITE/IIA/2005/1, pp.20–25. For a general look at the post-MFA transformation of Africa's apparel industry, see Broadman, *Africa's Silk Road, China and India's New Economic Frontier (Advance Edition)*, Washington, DC: World Bank (2006), pp. 149–151.

[14] See Don Lee, "Even Chinese Companies are Relocating to Cheaper Vietnam," *Los Angeles Times*, August 18, 2006.

[15] See "New Policy Stresses Quality of Foreign Investment," *China Daily*, November 10, 2006 at www.chinadaily.com.cn/bichina/2006-11/10/content_729989.htm; and "China's Economy—China Wants Higher Quality Foreign Investment," *The Economist*, November 13, 2006.

[16] Conclusion of a study by Morgan Stanley, cited in "A Survey of Business in India," *The Economist*, June 3, 2006, p. 14.

[17] *Ibid.*, pp. 15–16.

[18] Clive Harris, "Private Participation in Infrastructure in Developing Countries: Trends, Impacts, and Policy Lessons," World Bank Working Paper Number 5 (2003), pp. 6–15.

[19] World Bank, Public–Private Infrastructure Advisory Facility, "Private Activity in Infrastructure shows mixed results in 2005" (September 2006).

[20] Even in this bust period, private infrastructure investments are reported to have continued to advance in several low income countries—Cameroon, Togo, Niger, Azerbaijan, and India—perhaps testimony to how essential and adaptable these projects can be. See Clive Harris, "Private participation in Infrastructure in Developing Countries: Trends, Impacts, and Policy Lessons," World Bank Working Paper Number 5 (2003), pp. 8–9.

[21] On the basis of a sample survey of 35 countries, the World Bank estimated that South-South FDI amounted to $48 million in 2003 (*GDF 2006*,111). UNCTAD reports $37 billion in 2003 FDI receipts in developing and transitional economies from foreign investors based in these same economies, excluding FDI from offshore financial centers (*WIR 2006*, 117–118). Differences in how the World Bank and UNCTAD classify economies may account for some of the inconsistency.

[22] The observations are based on *WIR 2006*, pp. 117–136.

[23] *Ibid.* pp. 141–168.

[24] Harry G. Broadman, *Africa's Silk Road, China and India's New Economic Frontier (Advance Edition)*, Washington, DC: World Bank (2006), pp. 89–92.

[25] *GDF 2004*, pp.81–82.

[26] *WIR 2006*, pp. 198–199.

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

[4] For domestic enterprises, this point is reflected in an assessment of enterprise growth that concluded that productivity increases in the private sector can be accelerated if investment climate policy issues are resolved. See Development Alternatives, "Enterprise Growth Initiatives: Strategic Directions and Options" (February 2004). Recent analysis, however, shows that foreign and domestic investors may have relatively different concerns. FDI decisions may be more heavily affected by macroeconomic and political risk than domestic investment: FDI may be more influenced by privatization, a competitive environment, the level of technological development and lower regulation, while domestic investment is more influenced by availability of domestic credit. See IEG-World Bank, *Improving Investment Climates: An Evaluation of World Bank Group Assistance*, Washington DC: World Bank (2006), p. 71.

[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. Other analysts point out that "estimating the magnitude of the effect of institutions on FDI is difficult because there are not accurate measurements of institutions"—but still contend that the "quality of institutions is likely an important determinant of FDI." See Bruce A. Blonigen, "A Review of the Empirical Literature on FDI Determinants" NBER Working Paper 11299 (April 2005), pp.14–15.

[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 reach a vast market. Analysis by the Independent Evaluation Group of the World Bank, based on interviews with multinationals, confirms this and concludes that "diverse factors influence foreign investment decisions because firms are diverse." See IEG-World Bank, *Improving Investment Climates: An Evaluation of World Bank Group Assistance* (2006), pp. 71–72. However, it is reasonable to expect that the less unique a location's offerings, the greater the competition it will face for FDI and the more important its general investment climate.

[7] For a recent analysis of the relevance of macroeconomic, microeconomic and infrastructure improvements to attract FDI to *Africa, see Harry G. Broadman, Africa's Silk Road, China and India's New Economic Frontier (Advance Edition)*, Washington, DC: World Bank (2006), pp. 326-330.

[8] 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.

[9] 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*.

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

[11] McKinsey Global Institute, "The Truth About Foreign Direct Investment in Emerging Markets," *The McKinsey Quarterly*, 2004 Number 1.

[12] 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).

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

[14] The PFI is meant to advance the UN's Monterrey Consensus on Financing for Development, which emphasizes the importance of private investment in development strategies. The OECD Ministerial endorsed the PFI in May 2005. The full text of the OECD Policy Framework for Investment is available at www.oecd.org/dataoecd/1/31/36671400.pdf.

[15] OECD analyzed the principal investment scoreboards. It also estimated empirical models 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.

[16] MIGA's Enterprise Benchmarking Program is accessible at http://www.miga.org/index.cfm?aid=84; and UNCTAD Investment Policy Reviews: http://www.unctad.org/Templates/Page.asp?intItemID=2752&lang=1.

[17] The World Bank/IFC has set forth ten lessons for investment climate reform, together with illustrative case studies. Some lessons concern reform sequencing. All things being equal, one should begin with trade and product market reforms by exposing the economy to international competition, or use crisis and political change to undertake bold reform. Others lessons concern making good use of new information, often gathered through *Doing Business* and other benchmarking approaches, to build demand for reform and educate and empower reform constituencies. Still other lessons stress the importance of adopting private sector change management techniques to create incentives and capacity for implementing investment climate reforms, as well as introducing special oversight mechanisms and monitoring capabilities to make implementation transparent and accountable. See Sunita Kikeri, Thomas Kenyon, and Vincent Palmade, *Reforming the Investment Climate Lessons for Practitioners* (Washington DC: World Bank, 2006).

[18] *World Development Report 2005*, pp. 12–13. Performance requirements are "trade-related investment measures" (TRIMs), and WTO members were to eliminate such measures under the TRIMs Agreement by 2002. After the Hong Kong Ministerial of 2005, it was agreed that least developed countries could extend the phase-out period until 2020. Analysis by McKinsey Global Institute in such industries as automotive and electronics in Brazil, Mexico, China and India suggests that neither local content nor joint venture performance requirements have been particularly effective in stimulating spillovers, the typical justification for introducing them. Making markets competitive, McKinsey finds, is more effective. See "The Truth About Foreign Direct Investment in Emerging Markets," *The McKinsey Quarterly*, 2004 Number 1, pp. 32–34.

[19] *World Development Report 2005*, Box 5.5 "One-stop shops-or one more stop shops?" p.101.

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

[21] All EPZs seek to improve the performance of companies within them, but with different tools. Traditional EPZs are isolated from the economy, enjoy 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).

[22] *World Development Report 2005*, pp. 167.

[23] The WTO's Agreement on Subsidies and Countervailing Measures ties rules on policies in EPZs to country income. LDCs 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.

[24] See summary and survey of the benefits of EPZs in World Bank, *Global Economic Prospects 2003*, pp. 83–85. For an overview of EPZs, see Harry G. Broadman, *Africa's Silk Road, China and India's New Economic Frontier (Advance Edition)*, Washington, DC: World Bank (2006), pp. 139–143.

[25] World Bank, *Global Economic Prospects 2003*, pp. 81. Other research, however, shows that incentives have little influence on offshore location decisions for multinationals. See "The Truth About Foreign Direct Investment in Emerging Markets," *The McKinsey Quarterly*, 2004 Number 1, pp.30–32.

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

[27] For a favorable view of tax incentives and EPZs in attracting FDI to LDCs see Jeffrey Sachs, "The importance of investment promotion in the poorest countries," in Economic Intelligence Unit, *World Investment Prospects to 2010, Boom or Backlash?* (2006), p. 80.

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

[29] "Export platform" efficiency-seeking FDI may be the most sensitive to tax incentives, but even after Indonesia eliminated incentives 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).

[30] 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.

[31] For the case along these lines, see Jeffrey Sachs, "The importance of investment promotion in the poorest countries, in Economic Intelligence Unit, World Investment Prospects to 2010, Boom or Backlash? (New York: EIU, 2006), pp. 78–81. For an excellent summary of strategies used by poor countries to attract FDI, see Theodore H. Moran, *Harnessing Foreign Direct Investment for Development: Policies for Developed and Developing Countries*, Washington DC: Center for Global Development (2006), pp. 45-58.

[32] 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.

[33] 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).

[34] *World Development Report 2005*, p. 171.

[35] 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.

[36] MIGA, "Creating an Aftercare Program, Investment Marketing Services." The high proportion of FDI generated from aftercare of investors refers to MIGA's analysis of 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.

[37] 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).

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

[39] For an overview of IPA efforts to promote business linkages between foreign and investors and local enterprises, especially SMEs, see UNCTAD, "A Survey of Support by Investment Promotion Agencies to Linkages," UNCTAD/ITE/IPC/2005/12 (2006).

[40] *World Development Report 2005*, Box 8.12, p. 172.

CHAPTER 6

[1] Full text of the Monterrey Consensus is available at http://www.un.org/esa/ffd/

[2] BITs typically define investment broadly to include tangible and intangible assets and direct and portfolio investments, and they 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 prohibit "performance requirements," such as a

requirement to export a certain proportion of production or to use certain domestic inputs. Double tax treaties often accompany BITs, and serve to mitigate the problems of double taxation that foreign investors may face in both the home economy and the host economy as a result of income generated by foreign affiliates.

[3] UNCTAD, "Developments in international investment agreements in 2005," *ILA Monitor* No. 2 (2006) International Investment Agreements, UNCTAD/WEB/ITE/IIA2006/7

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

[5] At the end of 2006, the United States had 39 BITs in effect and another recently concluded. Western European countries have concluded the most BITs, though China now ranks second after Germany and Switzerland. The United States ranks about 25th.

[6] Although countries generally seek FDI and offer incentives (e.g., tax holidays or tariff exemptions on capital goods or raw materials) to attract it, many also 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 percent of foreign ownership, domestic content requirements for intermediate inputs, employment restrictions, export balancing, restraints on remittance of profits, 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.

[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 Non-binding Investment Principles (1994) of the Asia-Pacific Economic Cooperation 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] Major controversies in WGTI discussions have involved very basic issues, including definitions of "investment" and "investor," transparency, technical assistance, and development provisions. However, with the indefinite suspension of the Doha Round in July 2006, the WGTI's future may be moot, and it may simply disband, as several developing countries advocate.

[11] In May 1995 ministers of the 29 developed country members of the OECD began negotiating an 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 expected that developing countries might join the agreement once it was final. Although progress in refining investment principles was significant, they agreed to suspend negotiations in October 1998 in light of differences on issues such as treatment of regional economic integration organizations and disciplines on investment incentives and given the need to further consider concerns raised by environment and labor interests. The parties terminated negotiations in December 1998.

[12] 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 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 World Bank study concludes, for example, that FDI increased temporarily in Mexico when it joined NAFTA and in Spain and Portugal when they joined the EU. But the study found no clear evidence that that FDI was diverted from neighboring developing countries. Rather, the relative flows of FDI among RIA beneficiary countries in a region seemed to correlate more closely with 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,"2003.

[18] *WIR 2006*, p. 27.

[19] ASEAN has attempted to liberalize investment flows among members. 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, telecomunications, 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. On average, other investors and lenders provide more than $5 for every $1 of IFC financing. IFC alos syndicates loans with international commercial banks, underwrites investment funds, and provides business advisory services.

[23] See *World Development Report 2005*, p. 179.

APPENDIX A
Data on FDI Flows and Stocks

Table A-1

Inflows by Region and Country Income Group, 1970, 1980, and 1990–2005 (US$ million)

	1970	1980	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Developing Countries	3,369	9,021	25,554	34,509	50,989	73,866	91,004	110,551	133,002	175,306	173,849	187,221	174,003	182,198	168,470	168,566	230,376	285,144
Middle income	2,683	8,834	22,460	31,461	47,243	68,002	83,458	102,625	123,195	162,141	163,106	177,596	163,752	169,239	153,771	153,101	213,335	262,289
Upper middle income	1,496	3,986	11,915	18,569	24,923	25,712	31,932	42,804	47,027	67,734	60,066	83,194	72,169	75,782	60,106	59,700	96,950	116,579
Lower middle income	1,188	4,848	10,545	12,892	22,320	42,290	51,526	59,821	76,168	94,407	103,040	94,401	91,584	93,457	93,664	93,402	116,386	145,710
Low income	686	163	3,027	2,930	3,746	5,863	7,546	7,926	9,806	13,165	10,743	9,626	10,251	12,959	14,700	15,464	17,040	22,855
For reference: UN LDCs	154	536	579	1,580	1,573	1,928	1,122	1,705	2,072	3,821	4,861	6,001	4,067	7,125	6,595	10,868	8,740	9,680
East Asia and Pacific	417	1,713	11,304	13,690	21,795	39,697	45,911	54,255	62,541	65,774	60,213	52,195	47,546	50,453	60,220	60,139	72,224	89,700
Middle income	288	1,632	10,545	12,862	20,917	38,391	43,516	51,302	59,057	61,600	57,380	49,830	45,710	48,613	58,578	57,901	69,896	86,642
Upper middle income	94	933	2,736	4,366	5,141	5,740	4,581	5,817	7,303	6,454	2,772	3,907	3,814	565	3,205	2,475	4,631	3,970
Lower middle income	194	699	7,809	8,495	15,776	32,651	38,935	45,484	51,754	55,146	54,608	45,922	41,896	48,048	55,373	55,426	65,265	82,671
Low income	130	81	759	828	878	1,306	2,395	2,953	3,483	4,174	2,833	2,365	1,836	1,840	1,642	2,238	2,328	3,059
Europe and Central Asia	58	53	1,636	4,890	7,484	11,582	8,870	17,725	17,310	24,655	27,580	29,726	30,241	32,876	35,020	36,918	68,698	81,176
Middle income	58	29	1,569	4,771	7,466	11,515	8,747	17,643	17,155	24,387	27,300	29,554	30,145	32,779	34,914	36,788	68,250	81,030
Upper middle income	58	29	1,561	4,695	6,952	9,738	7,518	15,521	14,355	19,172	22,655	25,069	26,016	26,591	27,926	25,029	52,344	64,180
Lower middle income	0	0	8	76	514	1,777	1,228	2,122	2,800	5,215	4,646	4,484	4,129	6,188	6,987	11,759	15,906	16,849
Low income	0	0	0	0	18	67	123	82	155	268	279	172	96	97	106	129	449	147
Latin America and Caribbean	1,517	6,415	9,465	11,492	16,253	14,643	27,797	30,111	43,761	66,173	71,231	88,366	79,740	70,646	50,972	42,814	61,598	68,446
Middle income	1,514	6,402	9,457	11,478	16,254	14,646	27,799	30,113	43,757	66,169	71,220	88,336	79,727	70,641	50,966	42,801	61,592	68,436
Upper middle income	687	3,884	7,164	9,023	12,458	10,363	19,490	20,374	24,636	36,550	32,418	51,756	39,850	39,591	25,792	25,795	35,002	35,887
Lower middle income	827	2,518	2,293	2,455	3,796	4,283	8,309	9,739	19,121	29,619	38,802	36,580	39,877	31,051	25,174	17,006	26,591	32,549
Low income	3	13	8	14	-2	-2	-3	-2	4	4	11	30	13	4	6	14	6	10
Middle East and North Africa	477	380	895	1,399	2,506	3,748	2,534	1,321	1,859	5,038	4,344	4,480	5,303	6,769	5,493	8,493	7,787	15,840
Middle income	464	346	1,026	1,116	1,788	2,845	2,518	1,538	1,919	5,177	4,564	4,787	5,297	6,633	5,391	8,488	7,643	16,106
Upper middle income	320	-1,003	290	221	214	206	10	-25	28	1,797	1,108	783	1,188	1,323	1,590	3,491	1,745	3,549
Lower middle income	144	1,349	736	895	1,574	2,639	2,508	1,563	1,891	3,380	3,455	4,004	4,109	5,310	3,801	4,997	5,898	12,557
Low income	13	34	-131	283	718	903	16	-218	-60	-139	-219	-308	6	136	102	6	144	-266
South Asia	68	203	575	424	746	1,147	1,950	2,717	3,141	5,371	3,889	3,242	4,658	6,415	6,982	5,729	7,301	9,765
Middle income	0	43	49	74	129	201	175	72	142	444	162	213	186	184	209	242	248	286
Upper middle income	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Lower middle income	0	43	49	74	129	201	175	72	142	444	162	213	186	184	209	242	248	286
Low income	69	161	526	351	617	945	1,775	2,645	2,999	4,926	3,727	3,029	4,472	6,231	6,773	5,487	7,054	9,480
Sub-Saharan Africa	832	257	1,679	2,615	2,206	3,048	3,943	4,422	4,390	8,294	6,593	9,213	6,514	15,039	9,784	14,472	12,767	20,216
Middle income	360	382	-187	1,161	689	404	703	1,957	1,165	4,364	2,481	4,876	2,687	10,389	3,713	6,881	5,706	9,790
Upper middle income	337	143	163	264	159	-335	333	1,117	705	3,761	1,112	1,678	1,300	7,712	1,593	2,909	3,228	8,992
Lower middle income	24	238	-350	897	531	739	370	839	460	603	1,368	3,198	1,387	2,677	2,120	3,972	2,478	798
Low income	472	-125	1,866	1,455	1,517	2,644	3,240	2,466	3,225	3,931	4,113	4,337	3,827	4,650	6,071	7,591	7,061	10,426

Notes: "Developing countries" includes only economies classified as low or middle income by the World Bank (2005 per capita GNI of $10,725 or less). Totals for Europe and Central Asia for 1970, 1980, 1990 and 1991 include data from the former Socialist Federal Republic of Yugoslavia, but this country is not included in an income group.

SOURCE: UNCTAD, *World Investment Report 2006* for data on FDI inflows; World Bank, *World Development Report 2007* for regional groupings.

Table A-2

Estimated Value of Inward FDI Stock, by Sector and Industry, for Developing and Developed Countries, 1990 and 2004 ($ billion)

Sector and Industry	1990 Value (US$ billion)			2004 Value (US$ billion)			Change 1990-2004 (%)		
	Developed Countries	Developing Countries	World	Developed Countries	Developing Countries	World	Developed Countries	Developing Countries	World
Primary									
Agriculture, hunting, forestry, and fishing	3.2	4.1	7.3	7.7	14.8	22.6	142.4	264.8	210.9
Mining, quarrying, and petroleum	136.4	17.6	154.0	256.6	157.5	414.2	88.2	795.0	169.0
Unspecified	0.0	2.1	2.1	3.8	0.0	3.8	--	-100.0	84.8
Subtotal	139.6	23.7	163.3	268.2	172.4	440.5	92.1	626.8	169.8
Manufacturing									
Food, beverages, and tobacco	64.4	9.6	74.0	238.1	40.3	278.4	269.5	319.1	276.0
Textiles, clothing, and leather	21.4	5.0	26.5	78.5	7.9	86.4	266.3	56.9	226.6
Wood and wood products	18.5	4.4	22.9	77.4	13.4	90.8	318.0	206.4	296.7
Publishing, printing, reproduction of recorded media	13.9	0.5	14.4	55.9	0.3	56.2	303.1	-50.0	289.8
Coke, petroleum products, and nuclear fuel	50.2	3.0	53.2	65.5	24.7	90.1	30.5	716.6	69.4
Chemicals and chemical products	114.2	43.7	157.9	651.8	80.0	731.8	470.6	83.3	363.5
Rubber and plastic products	11.9	1.8	13.7	38.9	5.4	44.4	226.4	208.4	224.1
Non-metallic mineral products	15.5	2.7	18.3	63.1	9.8	72.9	305.6	259.0	298.7
Metal and metal products	46.3	14.5	60.8	176.9	21.6	198.5	281.8	49.1	226.3
Machinery and equipment	49.0	9.6	58.6	164.5	27.4	191.9	236.0	185.3	227.7
Electrical and electronic equipment	65.5	16.6	82.2	183.6	62.7	246.3	180.1	277.2	199.7
Precision instruments	10.9	0.5	11.3	73.0	1.5	74.4	572.1	218.3	557.8
Motor vehicles/other transport equipment	43.3	7.8	51.1	278.6	30.8	309.4	543.7	295.2	505.8
Other manufacturing	17.7	2.4	20.1	96.6	12.4	109.0	446.5	421.1	443.5
Unspecified secondary	43.6	22.3	65.9	163.9	295.9	459.7	275.9	1,227.2	597.8
Subtotal	586.4	144.4	730.8	2,406.1	634.0	3,040.1	310.3	339.1	316

Table A-2 (continued)

Sector and Industry	1990 Value (US$ billion)			2004 Value (US$ billion)			Change 1990-2004 (%)		
	Developed Countries	Developing Countries	World	Developed Countries	Developing Countries	World	Developed Countries	Developing Countries	World
Services									
Electricity, gas, and water	6.5	2.7	9.2	167.3	48.7	216.0	2,462.3	1,720.0	2,246.7
Construction	15.4	5.1	20.4	57.5	25.2	82.7	274.6	396.4	304.8
Trade	188.0	23.4	211.4	859.7	189.9	1,049.5	357.2	710.6	396.4
Hotels and restaurants	19.5	3.8	23.3	63.0	19.4	82.4	223.8	404.8	253.6
Transport, storage, and communications	15.1	11.3	26.4	366.6	130.7	497.3	2,323.3	1,056.9	1,782.0
Finance	272.7	85.3	358.0	1,518.1	306.5	1,824.6	456.7	259.3	409.7
Business activities	103.8	14.0	117.7	1,051.1	480.6	1,531.7	912.9	3,339.0	1,200.9
Public administration and defense	0.0	0.1	0.1	11.1	0.4	11.5	--	652.7	20,800.0
Education	0.1	0.0	0.1	0.5	0.1	0.6	496.6	--	580.5
Health and health services	0.9	0.0	0.9	8.6	2.5	11.1	835.9	--	1,113.5
Community, social, and personal services	12.3	0.0	12.3	68.3	5.9	74.2	456.0	29,470.0	503.2
Other services	66.5	3.9	70.4	107.3	31.5	138.8	61.4	711.3	97.2
Unspecified tertiary	15.8	2.0	17.8	345.9	17.3	363.2	2,088.1	746.7	1,934.9
Subtotal	716.5	151.6	868.1	4,625.0	1,258.6	5,883.6	545.5	730.3	577.7
Private buying and selling of property	0.0	0.0	0.0	6.4	0.0	6.4	--	--	--
Unspecified	9.7	4.1	13.8	47.4	78.1	106.6	388.7	1,824.2	675.1
TOTAL	1,452.2	323.7	1,775.9	7,353.1	2,143.1	9,477.4	406.3	562.0	433.7

Notes: Country groups are those used by UNCTAD. UNCTAD classifies some countries as "developing" that the World Bank considers "high income," such as Singapore and South Korea. UNCTAD also classifies others as "developed" that the World Bank classifies as "middle income" (e.g., Czech Republic, Estonia, and Hungary). Developing country data for 2004 include figures presented in WIR 2006 for South-East Europe and CIS countries.

SOURCE: UNCTAD, *World Investment Report 2006*, Annex Table A.1.2.

Table A-3

Estimated Distribution of Inward FDI Stock, by Sector and Industry, Developing Countries and Worldwide, 1990 and 2004

	Developing Countries				World			
			Percentage Point Change in Distribution				Percentage Point Change in Distribution	
Sector and Industry	1990	2004	Gain	Loss	1990	2004	Gain	Loss
Primary								
Agriculture, hunting, forestry, and fishing	1.3	0.7	--	0.6	0.4	0.2	--	0.2
Mining, quarrying, and petroleum	5.4	7.4	1.9	--	8.7	4.4	--	4.3
Unspecified	0.6	0.0	--	0.6	0.1	0.0	--	0.1
Subtotal	7.3	8.0	0.7	--	9.2	4.6	--	4.5
Manufacturing								
Food, beverages, and tobacco	3.0	1.9	--	1.1	4.2	2.9	--	1.2
Textiles, clothing, and leather	1.5	0.4	--	1.2	1.5	0.9	--	0.6
Wood and wood products	1.4	0.6	--	0.7	1.3	1.0	--	0.3
Publishing, printing, reproduction of recorded media	0.2	0.0	--	0.2	0.8	0.6	--	0.2
Coke, petroleum products, and nuclear fuel	0.9	1.2	0.2	--	3.0	1.0	--	2.0
Chemicals and chemical products	13.5	3.7	--	9.8	8.9	7.7	--	1.2
Rubber and plastic products	0.5	0.3	--	0.3	0.8	0.5	--	0.3
Non-metallic mineral products	0.8	0.5	--	0.4	1.0	0.8	--	0.3
Metal and metal products	4.5	1.0	--	3.5	3.4	2.1	--	1.3
Machinery and equipment	3.0	1.3	--	1.7	3.3	2.0	--	1.3
Electrical and electronic equipment	5.1	2.9	--	2.2	4.6	2.6	--	2.0
Precision instruments	0.1	0.1	--	0.1	0.6	0.8	0.1	--
Motor vehicles/other transport equipment	2.4	1.4	--	1.0	2.9	3.3	0.4	--
Other manufacturing	0.7	0.6	--	0.2	1.1	1.2	0.0	--
Unspecified secondary	6.9	13.8	6.9	--	3.7	4.9	1.1	--
Subtotal	44.6	29.6	--	15.0	41.1	32.1	--	9.1

Table A-3 (continued)

Sector and Industry	Developing Countries				World			
			Percentage Point Change in Distribution				Percentage Point Change in Distribution	
	1990	2004	Gain	Loss	1990	2004	Gain	Loss
Services								
Electricity, gas and water	0.8	2.3	1.4	--	0.5	2.3	1.8	--
Construction	1.6	1.2	--	0.4	1.2	0.9	--	0.3
Trade	7.2	8.9	1.6	--	11.9	11.1	--	0.8
Hotels and restaurants	1.2	0.9	--	0.3	1.3	0.9	--	0.4
Transport, storage, and communications	3.5	6.1	2.6	--	1.5	5.2	3.8	--
Finance	26.4	14.3	--	12.0	20.2	19.3	--	0.9
Business activities	4.3	22.4	18.1	--	6.6	16.2	9.5	--
Public administration and defense	0.0	0.0	0.0	--	0.0	0.1	0.1	--
Education	0.0	0.0	0.0	--	0.0	0.0	0.0	--
Health and health services	0.0	0.1	0.1	--	0.1	0.1	0.1	--
Community, social, and personal services	0.0	0.3	0.3	--	0.7	0.8	0.1	--
Other services	1.2	1.5	0.3	--	4.0	1.5	--	2.5
Unspecified tertiary	0.6	0.8	0.2	--	1.0	3.8	2.8	--
Subtotal	46.8	58.7	11.9	--	48.9	62.1	13.2	--
Private buying and selling of property	0.0	0.0	--	--	0.0	0.1	0.1	--
Unspecified	1.3	3.6	2.4	--	0.8	1.1	0.4	--
TOTAL	100.0	100.0			100.0	100.0		

Notes: The "developing countries" group conforms to UNCTAD classifications. UNCTAD classifies some countries as "developing" that the World Bank considers "high income," such as Singapore and South Korea. UNCTAD also classifies others as "developed" that the World Bank classifies as "middle income" (e.g., Czech Republic, Estonia, and Hungary). Developing country data for 2004 include figures presented in WIR 2006 for South-East Europe and CIS countries.

SOURCE: UNCTAD, *World Investment Report 2006*, Annex Table A.1.2.

Table A-4

Developing Countries' Share of Estimated Global Inward FDI Stock, by Sector and Industry, 1990 and 2004

			Percentage Point Change in Share	
Sector and Industry	1990 (%)	2004 (%)	Gain	Loss
Primary				
Agriculture, hunting, forestry, and fishing	56.0	65.7	9.7	--
Mining, quarrying, and petroleum	11.4	38.0	26.6	--
Unspecified	100.0	0.0	--	100.0
Subtotal	14.5	39.1	24.6	--
Manufacturing				
Food, beverages, and tobacco	13.0	14.5	1.5	--
Textiles, clothing, and leather	18.9	9.1	--	9.8
Wood and wood products	19.1	14.8	--	4.4
Publishing, printing, reproduction of recorded media	3.8	0.5	--	3.3
Coke, petroleum products, and nuclear fuel	5.7	27.4	21.7	--
Chemicals and chemical products	27.6	10.9	--	16.7
Rubber and plastic products	12.9	12.3	--	0.6
Non-metallic mineral products	14.9	13.4	--	1.5
Metal and metal products	23.8	10.9	--	12.9
Machinery and equipment	16.4	14.3	--	2.1
Electrical and electronic equipment	20.2	25.5	5.2	--
Precision instruments	4.1	2.0	--	2.1
Motor vehicles/other transport equipment	15.3	10.0	--	5.3
Other manufacturing	11.9	11.4	--	0.5
Unspecified secondary	33.8	64.4	30.5	--
Subtotal	19.8	20.9	1.1	--
Services				
Electricity, gas, and water	29.0	22.5	--	6.5
Construction	24.9	30.5	5.6	--
Trade	11.1	18.1	7.0	--
Hotels and restaurants	16.5	23.6	7.1	--
Transport, storage, and communications	42.7	26.3	--	16.5
Finance	23.8	16.8	--	7.0
Business activities	11.9	31.4	19.5	--
Public administration and defense	100.0	3.6	--	96.4
Education	0.0	12.3	12.3	--
Health and health services	0.0	22.9	22.9	--
Community, social, and personal services	0.2	8.0	7.8	--
Other services	5.5	22.7	17.2	--
Unspecified tertiary	11.4	4.8	--	6.7
Subtotal	17.5	21.4	3.9	--
Private buying and selling of property		0.0		
Unspecified	29.5	73.2	43.7	--
Total	**18.2**	**22.6**	**4.4**	**--**

Notes: The "developing countries" group conforms to UNCTAD classifications. UNCTAD classifies some countries as "developing" that the World Bank considers "high income," such as Singapore and South Korea. UNCTAD also classifies others as "developed" that the World Bank classifies as "middle income" (e.g., Czech Republic, Estonia, and Hungary). Data for 2004 include figures presented in WIR 2006 for South-East Europe and CIS countries.

SOURCE: UNCTAD, *World Investment Report 2006*, Annex Table A.1.2.

APPENDIX B
Publications and Resources

Resource and Availability	Description
General Investment Flows and Trends	
Economist Intelligence Unit, 2006. *World Investment Prospects to 2010 Boom or Backlash?* New York: The Economist Group. Written with the Columbia Program on International Investment.	Analysis and forecast of FDI flows with detailed assessment of FDI drivers and past and future performance of developed countries and emerging markets. Includes separate paper on investment promotion for poorest countries.
Institute of International Finance Inc. 2006. Capital Flows to Emerging Market Economies. Available to members at http://www.iif.com	Discusses current annual 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/ 2003/eng/091803.pdf	Explains shifts in types of FDI (prepared by a Capital Markets Consultative Working Group).
Kearney, A.T. 2005. FDI Confidence Index. Available at www.atkearney.com/shared_res/pdf/FDICI_2005.pdf	Analysis and projection of FDI flows by region and key country. Produced annually.
Organization for Economic Co-operation and Development (OECD). 2006. Trends and Recent Developments in Foreign Direct Investment. http://www.oecd.org/dataoecd/54/58/37010986.pdf	Annual report on FDI flows and their 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. 2006. FDI in Least Developed Countries at a Glance: 2005/2006. http://www.unctad.org/en/docs/iteiia20057_en.pdf	Close examination of flows, stocks, largest greenfield projects, largest foreign affiliates (nonfinancial) and FDI-related liberalization measures in the poorest countries.

Resource and Availability	Description
UNCTAD. 2006. *World Investment Report: FDI from Developing and Transition Economies: Implications for Development.* http://www.unctad.org/Templates/Search.asp?intItemID=2068&lang=1&frmSearchStr=wir&frmCategory=all&section=whole	Annual flagship report, focusing in 2006 on the implications of South-South FDI flows for host and home developing economies.
UNCTAD. 2005. *Transnational Corporations and the Internationalization of R&D.* http://www.unctad.org/Templates/Search.asp?intItemID=2068&lang=1&frmSearchStr=wir&frmCategory=all&section=whole	Annual flagship report, focusing in 2005 on offshoring of R&D and the role of foreign affiliates in providing R&D services, including impacts in host and home economies.
UNCTAD. 2004. *World Investment Report: The Shift Toward Services* http://www.unctad.org/Templates/Search.asp?intItemID=2068&lang=1&frmSearchStr=wir&frmCategory=all&section=whole	Annual flagship report, focusing in 2004 on growing importance of FDI in services and drivers behind this trend.
UNCTAD. 2003. *World Investment Report: FDI Policies for Development: National and International Perspectives.* http://www.unctad.org/Templates/Search.asp?intItemID=2068&lang=1&frmSearchStr=wir&frmCategory=all&section=whole	Annual flagship report, focusing in 2003 on role of policies and international agreements in attracting FDI and ensuring that developing countries benefit from it.
UNCTAD. 2002. *World Investment Report: Transnational Corporations and Export Competitiveness.* To order, go to http://www.unctad.org/Templates/WebFlyer.asp?intItemID=2477&lang=1	Annual flagship report that measures and analyzes trends in global and regional FDI, especially the role of transnational corporations in developing countries' export competitiveness. Includes statistical annex.
UNCTAD. 2001. *World Investment Report: Promoting Linkages.* http://www.unctad.org/Templates/Search.asp?intItemID=2068&lang=1&frmSearchStr=wir&frmCategory=all&section=whole	Annual flagship report, focusing in 2001 on linkages between foreign affiliates of multinational enterprises and local companies in developing countries.
World Bank. 2006. Global Development Finance—The Development Potential of Surging Capital Flows. Washington DC: World Bank (2 Volumes). http://econ.worldbank.org/WBSITE/EXTERNAL/EXTDEC/EXTDECPROSPECTS/EXTGDF/EXTGDF2006/0,,menuPK:2344945~pagePK:64167702~piPK:64167676~theSitePK:2344908,00.html	Analyzes FDI and other capital flows to the developing world for 2005, focusing on financial integration in the developing world and summarizing lessons learned and the related policy agenda for managing capital flows.
World Bank. 2005. Global Development Finance—Mobilizing Finance and Managing Vulnerability. Washington DC: World Bank (2 Volumes). http://econ.worldbank.org/WBSITE/EXTERNAL/EXTDEC/EXTDECPROSPECTS/EXTGDF/EXTGDF2005/0,,menuPK:544398~pagePK:64167702~piPK:64167676~theSitePK:544381,00.html	Analyzes FDI and other capital flows to the developing world for 2004, with particular look at challenges of developing country debt and meeting financing needs of poor countries.
World Bank. 2005. Global Economic Prospects: Trade Regionalismand Development. Available at http://worldbank.org/prospects/gep2005/toc.htm	Reviews trends and developments to 2004 that affect global and domestic dimensions of developing countries' investment climates.
World Bank. 2003. Global Economic Prospects and the Developing Countries: Investing to Unlock Global Opportunities. Available at http://worldbank.org/prospects/gep2003/toc.htm	Reviews trends and developments to 2002 that affect global and domestic dimensions of developing countries' investment climates.

Resource and Availability	Description
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 forSustainable 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 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: Globalization and Fiscal Sovereignty.* Edited by RajivBiswas. 2002. 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 onTrade and Investment, the TRIMS, and the GATS.
UNCTAD. 2006. "Developments in international investment agreements in 2005," *ILA Monitor* No. 2 International Investment Agreements, UNCTAD/WEB/ITE/IIA2006/7 http://www.unctad.org/Templates/Page.asp?intItemID=3974&lang=1	Quarterly monitor that tracks trends and issues investment agreements, both BITS, and free trade agreements.

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/ Final%20Report%20on%20Regional%20Investors%20Roadmap/view	Seeks to understand how to increase cross-border investment in COMESA.
Kikeri, Sunita, Thomas Kenyon, and Vincent Palmade. 2006. Reforming the Investment Climate Lessons for Practitioners. Washington DC: World Bank. http://extsearch.worldbank.org/servlet/SiteSearchServlet?qUrl=&qSubc=wbg&ed=&q=%22Reforming+the+investment+climate+lessons+for+practitioners%22&submit.x=18&submit.y=6	Analyzes lessons for reforming investment climates, with case studies.
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 how administrative barriers to starting a business in developing countries affect the attraction of FDI.
OECD. 2006. Policy Framework for Investment www.oecd.org/dataoecd/1/31/36671400.pdf.	Guides assessment, framing, and monitoring of policies to strengthen investment climates, focusing on 10 policy domains.
Proposal for the Establishment of a Regional Investment Agency for COMESA. Available at http://www.comesa.int/investment/regimes/ investment_area/Project%20Proposal%20For%20The%20Establishment%20Of%20A%20Regional%20Investment%20Agency%20%28Ria%29%20For%20Comesa/view	Details rationale and justification for setting up a regional investment agency to promote investment in COMESA.
World Bank. 2006. *Doing Business 2007: How to Reform. Comparing Regulation in 175 Economies.* Can be viewed and purchased at http://www.doingbusiness.org/main/downloads.aspx	Provides and explains quantitative indicators to inform foreign investors and domestic firms about the business regulatory environment and costs of doing business in 175 countries.
World Bank, July 2006. The Independent Evaluation Group. Improving Investment Climates, An Evaluation of World Bank Group Assistance.	Assesses the effectiveness of the World Bank, the IFC, and MIGA in helping member countries improve investment climates and recommends strategies and activities.
World Bank. 2004. *World Development Report 2005: A Better Investment Climate for Everyone.* Available by searchinghttp://publications.worldbank.org/ ecommerce/	Argues that improving investment climates should be a top priority of governments and offers practical insights for policy makers, executives, and scholars.

Resource and Availability	Description
Investment Promotion	
Chantasasawat, Busakorn, K.C. Fung, Hitomi Iizaka and Alan Siu. June 2005. "Foreign Direct Investment in East Asia and Latin America: Is There a People's Republic of China Effect?" ADB ResearchPaper Series No. 66.	Addresses notion that China is diverting FDI from other parts of the developing world. Suggests that this is not the case: China may help increase flows, and countries attract FDI through quality of investment climate.
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 nontransparent government policies on FDI inflows.
Foreign Investment Advisory Service (FIAS). Institutional Frameworkfor Attracting FDI and the Importance of an Investment PromotionStrategy. http://www.fias.net/html/services_institutional_framework.htm	Explains 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.
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.
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.
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.

Resource and Availability	Description
UNCTAD. 2001. The World of Investment Promotion at a Glance—A survey of investment promotion best practices. ASIT/UNCTADAdvisory 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 are 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.
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://econ.worldbank.org/docs/739.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.
Broadman, Harry, G., 2006. *Africa's Silk Road, China and India's New Economic Frontier* (Advance Edition), Washington, DC: World Bank.	Reviews and analyzes the role of trade and FDI from China and India in Africa, including policy reforms required to attract FDI and improve linkages between FDI and trade flows.
Broadman, Harry G., (ed.). 2005. *From Disintegration to Reintegration, Eastern Europe and the Former Soviet Union in International Trade,* Washington DC: World Bank	Reviews and analyzes the role of trade and FDI in reintegrating the former Soviet Union and Eastern Europe into international trading system, including policy reforms required to attract additional FDI and to improve linkages between FDI and trade flows.
Caves, Richard. 1999. Spillovers from Multinationals in Developing Countries: The Mechanisms at Work. Working Paper 247. Michigan: William Davidson Institute. Available at http://eres.bus.umich.edu/docs/workpap-dav/wp247.pdf	Reviews theoretical and empirical literature on spillovers.

Resource and Availability	Description
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 tohttp://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).
Graham, Edward M. (ed). 2005. Multinational and Foreign Investment in Economic Development. New York: Palgrave Macmillan and International Economics Association.	Papers from the 13th Congress of the International Economic Association in Lisbon Portugal, 2002. Papers (by Graham, Kumar and Pradhan, Agrawal, Castilho and Zignago, De Gregorio and S. Gupta, and others) examine FDI trends and impacts in South Asia, China, Latin America and Africa, covering such issues as externalities, spillovers, and why more FDI does not flow to the developing world.
Hoekman, Bernard, and Beata Smarzynska Javorcik (eds.) 2006. *Global Integration & Technology Transfer.* Washington DC: World Bank and Palgrave Macmillan.	Articles by Saggi, Tybout, Kraay, Djankov and Hoekman, Javorcik, Lederman and Maloney, and others on lessons from empirical research on international technology diffusion through trade and FDI.
Kokko, Ari. 1996. Productivity Spillovers from Competition BetweenLocal 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. 2006. *Harnessing Foreign Direct Investment for Development.* Washington DC: Center for Global Development. Available at: http://www.cgdev.org/content/publications/detail/12044	Builds on earlier work to set forth the impacts of FDI on development—both good and bad—for manufacturing industry and for extractive sectors. Good outline of how countries have or have not harnessed FDI, including investment promotion, linkage-building, and worker rights.

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.
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.
Moran, Theodore, Edward M. Graham and Magnus Blomström, (eds.). 2005. *Does Foreign Direct Investment Promote Development?* Washington DC: Institute for International Economics and Center for Global Development.	Several articles (Lipsey and Sjöholm, Javorcik and Spatareanu, Blalock and Gertler, Carkovic and Levine, Blonigen and Wang, Moran and others) present new research on searching for FDI externalities and spillovers, impact of FDI on growth, and designing policies to capture benefits.
OECD. 2002. *Foreign Direct Investment for Development: Maximising Benefits, Minimising Costs.* Available for purchase 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, environmental issues, and development.

Resource and Availability	Description
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 InvestmentCrowd out Domestic Entrepreneurship? Economic Working Paper No. 618. Department of Economics and Business, Universitat Pompeu Fabra. Available for purchase at http://ideas.repec.org/p/upf/upfgen/618.html	Explores the short- and long-term implications of FDI for domestic entrepreneurship.
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://eres.bus.umich.edu/docs/workpap-dav/ 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.
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.
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.
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.

Resource and Availability	Description
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.
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ILO. Confronting the Social and Labor Challenges of Privatization: Multinational Enterprises in Telecommunications in 1990s. Working Paper No. 90. Geneva: Multinational Enterprises Programme. 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.unireps.com.au/isbn/ 0815706154.htm	Analyzes the labor practices of multinational corporations and evaluates the need for an international agreement to enforce labor standards.
OECD. 2005. Environment and the OECD Guidelines for Multinational Enterprises Corporate Tools and Approaches. Paris: OECD Publishing. http://www.oecd.org/document/12/ 0,2340,en_2649_201185_35315020_1_1_1_1,00.html	Explains and recommends tools and approaches for implementing the environment chapter of OECD Guidelines for Multinationals.
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.

Asian Financial Crisis. A period of turmoil in the economies of East and Southeast Asia. The crisis began in Thailand in July 1997 and spread to other countries, including Thailand, Malaysia, Hong Kong, Indonesia, and South Korea. Secondary effects were felt outside the region in countries such as Russia and Brazil. Countries suffered large fluctuations in their currencies and large-scale withdrawal of capital by investors. FDI did not fluctuate nearly as widely as short-term capital flows, such as portfolio investment.

Balance of payments. A summary of the flow of trade and capital in and out of a country. FDI 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.

Build, Own, Operate project (BOO). A form of private financing of public infrastructure, in which a private company builds the physical structure or system (road, railway, etc.), retains ownership of it, and operates it.

Build, Operate, Transfer project (BOT). A form of private financing of public infrastructure in which a private company builds the physical structure, operates it for a specified period, and then transfers ownership to the public sector. The transfer date is usually set to allow the company to recoup the costs of construction plus an agreed rate of profit.

Business enabling environment (or business environment). Sum of factors that determine the ease with which one may establish and operate a business in a particular location. The business enabling environment includes macroeconomic factors such as inflation and the exchange rate; procedures for starting and closing a business; tax policy; the quality of infrastructure; labor regulations; the extent of corruption; and the depth and breadth of the financial sector. Indicators such as the World Economic Forum's Global Competitiveness Index and the World Bank's Doing Business surveys measure the quality of the environment. *See investment climate.*

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 a specified interest rate, either fixed or flexible (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.*

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

Doing Business. A World Bank program that measures the quality of the business environment in 175 economies. It scores the quality of the environment in ten topical areas: starting a business, dealing with licenses, employing workers, registering property, getting credit, protecting investors, paying taxes, trading across borders, enforcing contracts, and closing a business. Annual updates allow comparisons over time.

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. The deindustrialization of a country tied to a sustained rise in the value of its currency making the country's manufactured exports less competitive. In this situation, large and rapid inflows of foreign exchange lead to a sharp increase in the country's real exchange rate. These inflows typically result from a boom in primary exports, but also possibly from large-scale foreign investment or foreign assistance loans from donor organizations. The inflows stimulate domestic inflation, which causes the real exchange rate to appreciate and thus render the country's manufactured exports uncompetitive in world markets.

Efficiency-seeking foreign direct investment. Capital expenditure to create foreign-based facilities to pursue reduction in input costs and in other costs of production, 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 ownership 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 output is sold in a third market rather than the host country.

Export processing zone (EPZ). Areas with their own customs clearance procedures and financial incentives for attracting export-related investment. These may be geographic areas isolated from the surrounding economy and which 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.

Free Trade Agreement (FTA). An arrangement between two or more nations to remove barriers to the trade they conduct with one another. FTAs sometimes include provisions on investment: for example, the U.S. FTAs with Chile, Morocco, Singapore, and Australia contain investment chapters.

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.* See *network trade.*

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

Guidelines for Multinational Enterprises. OECD-sponsored recommendations for multinational enterprises operating in or from adhering countries, including the 30 OECD member countries and nine other countries: Argentina, Brazil, Chile, Estonia, Israel, Latvia, Lithuania, Romania, and Slovenia. The guidelines provide principles and standards for conducting business in a variety of areas, including employment and industrial relations, human rights, environment, information disclosure, competition, taxation, and science and technology.

Home country. Country of incorporation of a foreign investor.

Horizontal spillovers. Technology transfers among rival firms competing for customers in the market for a given product or service. These transfers may occur because of demonstration effects and labor mobility of workers among rival firms.

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 the characteristics that determine the ease and attractiveness of investing in a particular country. The investment climate reflects the general *business enabling environment,* including such factors as government regulations on foreign investment and investment incentive programs. Investment climates are monitored and measured through the World Bank's *Doing Business* indicators, enterprise surveys, and investment climate assessments; OECD and UNCTAD investment policy reviews; UNCTAD's Investment Compass; and other investment policy "scoreboards."

Investment dispute settlement. Confidential process for hearing and resolving disputes between governments and foreign investors. The International Centre for Settlement of Investment Disputes 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 for new products through additional, higher-value 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 nontangible 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 1998.

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 quotas on the most competitive, large-scale producers, producers in other low-cost sites (primarily poorer developing countries) were able to attract foreign direct investment to the apparel sector. Elimination of the quotas was agreed in 1995 under the World Trade Organization Agreement on Textiles and Clothing, and phased in over a ten-year period. Quotas were abolished in January 2005. Many 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.

Newly Industrialized Economies (NICs). Former developing countries that have experienced such rapid and sustained economic growth that they are now viewed as developed. The term was originally used in reference to East Asian countries, such as Taiwan, South Korea, and Singapore, but it is sometimes used in reference to countries outside that region.

Network trade. Trade within a given product supply chain, featuring flow of parts, components, and other intermediate items to produce a final good. A key characteristic of global production chains. Contrasts with more traditional trade in final goods. See *global production chains.*

Organization for Economic Co-operation and Development (OECD). Paris-based organization comprising 30 member countries (primarily developed) committed to democratic government and the market economy. The OECD is best known for its publications 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 manufacturer relocates auto parts production to Morocco). 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, in the home country or overseas. 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 exported, or contain a specified proportion of local content.

Policy Framework for Investment (PFI). A series of OECD guidelines for creating a high-quality climate for foreign and domestic investors. The guidelines cover ten policy areas: investment policy, investment promotion and facilitation, trade policy, competition policy, tax policy, corporate governance, policies for promoting responsible business conduct, human resource development, infrastructure and financial sector development, and public governance.

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 due to discovery or us of new production processes or technologies.

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 nontangible 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 agreed 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 to host-country firms or sectors through interaction with direct investment enterprises. See *vertical and horizontal spillovers.*

Stock, FDI. Total value of foreign-owned assets in a country at a given point in time. Can be measured in terms of inward or outward flows of FDI.

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 a broad range of issues, including services, investment, trade in goods, and intellectual property protection. A TIFA is generally a prerequisite 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 all activities for 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.

Vertical spillovers. Technology transfers up and down a product or service supply chain. The main mechanism for such transfers is the training and technical advice provided by foreign affiliates to upstream suppliers or downstream producer-customers.

U.S. Agency for International Development
1300 Pennsylvania Avenue, NW
Washington, DC 20523
Tel: (202) 712-0000
Fax: (202) 216-3524
www.usaid.gov