Foreign direct investment, development and the new global economic order. A policy brief for the South

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A Policy Brief for the South

Foreword

In 1996 when advanced industrial countries were proposing that discussions and negotiations should take place within the WTO on a multilateral investment agreement, the Chairman of the South Centre, Julius K. Nyerere, highlighted in a letter to Heads of State or Government (September 1996), the need for careful deliberation on the part of all developing countries about the merits of engaging in such discussions and negotiations. The letter was accompanied by a note entitled *Current Proposals Concerning a Global Regime for Foreign Direct Investment. Important Concerns of the South.* This current document corresponds to a commitment made in Mr. Nyerere's letter that the South Centre would provide a more in-depth analysis of FDI and the policy issues this raises for developing countries.

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Preface

Over the last decade and a half the global economic order has been undergoing major changes. While this may be thought to reflect the results of a multilateral and participatory process involving debate and negotiations, in reality it has been mostly driven by the economic interests of the North. The developing countries have been marginal participants, often feeling they have little choice but to follow Northern proposals. They have had little impact on the final outcomes in terms of the shape of the emerging global economic structures and policy regimes. Yet, these outcomes and structures are likely to prove a major and often determining factor in their future development, for better or for worse.

Although the North achieved many of its objectives in the Uruguay Round, its proposals for a new liberal world economic order have still not been fully realized. One of the most important objectives still outstanding is a highly liberalized international regime governing foreign direct investment (FDI), with the policy emphasis on securing the rights of foreign investors and defining the obligations of host country governments.

The purpose of this policy brief is to assist developing countries assess individually and as a group their response to the current drive for a global regime to establish free flows of FDI. The bulk of the document is therefore devoted to a review of the key economic issues that need to be taken into account by developing countries in shaping their policy stand on FDI matters. The rest of the document is mainly devoted to reviewing the related challenge they currently face in the international policy and negotiating arena and outlines some options. This preface, however, draws attention to the broad political context in which national policies are formulated, and multilateral discussions and possibly negotiations on such matters take place.

In a world in which ODA flows are steadily diminishing and bank credit more difficult to obtain, and in which portfolio investment carries its own risks, developing countries are now eager to attract other types of financial flows from abroad to meet their domestic needs. FDI has therefore come to be considered as a major source of funds which also contributes to development in other ways, including through deeper integration into the world economy with the growth potential this is deemed to offer.

This represents a significant change in attitude in the South vis-à-vis FDI. Reserve, open hostility or even ideological suspicion, which were partly rooted in the colonial experience, no longer dominate attitudes to FDI. Today, the pendulum has swung the other way and FDI is now depicted as beneficial under all circumstances, and widespread acceptance of the policy tenets of liberalization and globalization has given rise to pressures for the full liberalization of FDI regimes.

In fact FDI is now widely seen as the major key to development in all developing countries, even as a means to achieve economic salvation. Developing countries therefore try to compete in offering investment incentives in order to make themselves attractive to foreign investors. Socially and politically, foreign investment is becoming a major influence in national politics, affecting day-to-day decision-making both directly and indirectly, and defining national models of development in many developing countries.

The general enthusiasm regarding the potential gains from FDI partly explains the lack of public debate on the role or merits of FDI, or on the nature of the global rule-based arrangements for FDI being pressed for by the North. Yet, for the South as a whole, it is a strategic issue whether their positive attitude to FDI at country level should necessarily be translated, willingly or by default, into an acceptance of a global investment regime embodying terms and conditions such as those being negotiated by the North within OECD. There are powerful arguments to suggest that this or any similar regime would not necessarily promote widespread growth and development or take account of developing countries' socio-economic or political pre-occupations. Moreover, similar reservations arise with regard to the global rules of the game that are being formulated on investment-related items on the in-built agenda of the Uruguay Round.

Normal self-interest would suggest that developing countries should be extremely cautious about accepting arrangements devised by the North and which do not work in favour of their interests. Indeed, the Uruguay Round experience demonstrated the costly consequences both of failing to take a collective stand and of the lack of effective negotiating skills such that, in some areas, developing countries, to their cost, exercised little influence on the definition of the issues and on the final policy outcomes.

Hence, a fundamental policy issue facing the leaders and governments of the South is whether developing countries should jointly define their interests and demands with respect to global FDI matters and mobilize themselves as a group to act in the international arena. Developing countries vary widely in their characteristics and often their views on FDI differ. Nevertheless, as this document indicates, there are policy options which would serve the interests of all developing countries, all of whom recognize that individually they have little or no political or economic weight in the international debate and negotiations on North proposals for global FDI policies.

The challenge, however, is considerable. For, in addition to the legitimate dilemmas inherent in each country's stance and the predominant world-wide policy climate uncritically favouring FDI, there are strong external pressures on most developing countries to conform with what in essence would be an investor-oriented agreement and which de facto significantly circumscribes the exercise of sovereign power by developing country nation states in their own territory. In a world of uneven development and great disparities in economic and political power among states, the asymmetries are such that entering the kind of multilateral investment arrangements pressed by the North would represent an unfair and unequal bargain and could have undesirable consequences for developing countries.

Summary of key points

The central issue at stake

In recent years there has been a considerable change in the attitude of developing countries towards FDI, from a previous emphasis on its drawbacks to the point where these are now almost overlooked. The possibility of receiving additional capital resources to finance their development is highly attractive to developing countries, especially in view of the marked decline in flows of ODA, as well as of private bank credit in the wake of the debt crisis. Moreover, it has come to be recognized that portfolio investment, despite its initial high promise as a source of foreign capital, often entails a number of problems. FDI, in addition to bringing additional finance, also offers prospects for, among other things, delivering new technology and creating new jobs. For many developing countries, therefore, the central question has become how "to foster an enabling environment" so as to attract FDI.

The key issue for developing countries is whether this framework should be one which embodies a free investment regime. This question assumes special importance in an era of increasing global economic liberalization and in which considerable efforts are being made by the advanced industrial countries of the North to persuade developing countries of the virtues of removing the remaining restraints on FDI.

Costs and benefits of FDI

While recognizing fully the potential of foreign investment for helping achieve development objectives and the key role of FDI in the integration of the global economy, this document draws attention to the costs which tend to be overlooked in the current climate of enthusiasm regarding FDI. The document emphasizes that it cannot be presumed that the net socio-economic impact of FDI will in all circumstances be positive. In particular, **the document presents reasons for questioning whether, in all cases, the cheapest and most appropriate means of obtaining foreign financial resources and desired technology is by means of FDI.**

An optimum level of FDI

More importantly, however, **this document draws particular attention to the special hazards FDI poses for developing countries in the context of financial liberalization and increasingly sophisticated financial markets. The potentially serious problems posed for the balance of payments, foreign exchange markets and macroeconomic management are frequently overlooked**

or underestimated by the international financial institutions and those advocating free flows of FDI.

In view of the considerable risks attached to accepting any and all FDI, that is, of adopting an undiscerning approach to FDI, a central argument of this document, therefore, is that, from the point of view of long-term financial stability and therefore economic development, **there is an optimum level of flows and stock of FDI for any particular developing country, just as, by analogy, there is an optimum level of sustainable debt.**

In this context, the document suggests that **developing countries should press for further careful in-depth empirical research work to be carried out by UNCTAD and WTO and the UN regional economic commissions on key issues relating to FDI flows and economic stability and financial fragility.**

Encouraging FDI

Incentives to attract FDI

Many countries, developed and developing, now offer investment incentives to attract FDI. There is overwhelming evidence, however, to suggest that incentives are a relatively minor factor in the location decisions of TNCs relative to other locational advantages, such as market size and growth, production costs, skill levels, political and economic stability and the regulatory framework. Nevertheless, the way the competitive game in incentives is being played by governments at present, no country can afford to refrain from offering investment incentives from fear that potential investment will flow to similarly placed countries with respect to locational advantages but which also offer investment incentives. **Developing countries as a whole lose collectively from competition among themselves in offering ever greater incentives packages to attract FDI. Collectively and individually developing countries would gain from co-operation rather than competition in this sphere.**

A free investment regime

Whether an OECD-type MAI would generate greater FDI than would be the case if such an agreement did not exist raises well-grounded doubts.. **The huge increase in FDI in the last ten years has taken place without any multilateral investment agreement and, importantly, there does not seem to be much correspondence between the liberality of a country's FDI regime and the inflows of FDI which it receives**.

Essential policy conditions to derive the optimum benefit from FDI

While recognizing that **FDI can and does make a positive contribution to a country's socio-economic development in a number of ways, the document emphasizes that, in order to realize FDI's full potential, it is necessary to pursue a policy of:**

- ***selectivity with respect to specific projects***, with preference for those with large technological spill-overs or other socio-economic benefits. This may involve limiting FDI to economic sectors and sub-sectors regarded as priorities in the country's overall socio-economic development.

- ***selectivity with respect to the magnitude and timing of capital inflows including FDI***. This implies that governments should be free to determine the composition of capital inflows and be able to formulate appropriate policies of government intervention to manage capital inflows, including those of FDI;

- ***prudence with respect to total FDI flows as well as FDI stock*** so as not to render the economy financially more fragile in the context of future economic shocks.

Thus, **a global investment regime, which divested a developing country of the right to select among FDI projects and to regulate inflows for macro-economic reasons would hinder development and prejudice economic stability.** Experience shows that an erosion of government autonomy in decision-making could have serious economic, social and political consequences.

The broad contours of a policy framework for FDI

To help developing countries, both individually and as a group, to define the kind of policy framework with respect to FDI which would best serve their development interests, **the document outlines the broad contours of what may be termed a "development-friendly" FDI policy framework**. **This framework would at least need to include elements which**:

- ***allowed countries to be selective with regard to the timing of FDI and to actual FDI projects***, according to the current development level and needs;

- ***legitimized "qualified" market access*** so that a potential host country could specify the degree to which it would give national access, in terms of the percentage limit on foreign shareholding, or the total value of individual or aggregate foreign investment;

- ***prevented the abuse of monopoly power by large multinationals***, encouraging, as far as possible, level playing fields between large foreign investors and smaller domestic companies so that the latter can survive and flourish.

- ***permitted limitations to national treatment****,* giving governments scope to stipulate performance requirements and similar measures, TRIMs not withstanding, in order to encourage foreign enterprises to contribute to development objectives, including a healthy balance of payments***;***

- ***established rules of conduct for foreign investors*** to prevent bribery and corruption and tax avoidance through transfer pricing, among other things.

To provide a credible and predictable environment for overseas investment, whether by the North or the South, ground rules would be needed **to**:

- ***guarantee the protection of investment; and***

- ***provide an appropriate dispute settlement mechanism, suitably designed to take account of developing countries' circumstances.***

Moreover, if, in the light of events, it is concluded that there has to be a multilateral regime for FDI rather than continue under the present regime of bilateral and regional agreements, **an approach worth considering is that based on a "positive" list approach to liberalization of FDI**, whereby each country specifies the economic sectors and industries, if any, in which it is willing to open up to foreign investors and in which it is willing to assume the treaty obligations. This would **give each developing country the scope to determine its own pace and approach to the liberalization of FDI. It would also make it easier for developing countries to negotiate together and pre-empt a potentially damaging division within the South.**

Such an approach is not wholly idealistic. The General Agreement on Trade in Services (GATS), which has been negotiated as part of the Uruguay Round, provides an important partial precedent, in that it allows countries to choose the areas and the degree to which they wish to open up to foreign investment in their services sector and permits an evolution of their position over time in accordance with national policy objectives. However, in contrast with the GATS agreement, where there is a sector by sector rolling programme, the proposal here envisages that countries could offer, or not as the case may be, liberalization in any sectors whatsoever and not in predetermined broad sectors.

Competition policy

The significance of competition policy at both the national and the international levels for developing countries in the context of a liberalising global economy is highlighted in the document. These competition policy issues would become critical if developing countries were eventually to engage in negotiations on an ultra liberal multilateral FDI regime of the sort envisaged by the OECD. In any case **what is at issue is the kind of competition policies, national and international, which are necessary if the South is to be able to develop. Developing countries as a group will need to promote their own ideas on "development friendly" competition policies.**

Strategy options open to the South

Finally the document outlines **the strategy options available to developing countries to deal with the situation facing them on FDI matters at the multilateral level.** In the short and medium term, they have to contend with the impending discussions and negotiations on the Uruguay Round in-built agenda; the discussions on the results of the UNCTAD and WTO studies on investment and competition matters, and, importantly, the evolving OECD multilateral investment agreement.

It is suggested that **it will be essential for the South to take a coordinated and integrated approach to the various FDI-related matters on the agenda.**

Part I. The Impetus for a Multilateral Regime for Foreign Direct Investment: A Key Policy Challenge for the South

A. The impetus for a global investment regime

During the Uruguay Round of trade negotiations, the industrial countries of the North also advanced the idea of framing global rules to achieve the liberalization of foreign investment. The idea of negotiating or even discussing such a multilateral investment agreement was, however, strongly contested by many developing countries, including the leading ones among them. This was principally on the grounds that developing countries were unwilling to embark on multilateral negotiations on investment matters under the GATT which they regarded as essentially a body devoted to trade matters; that a multilateral agreement would be binding and hold the threat of potential cross sanctions for transgressors; and that developing countries were wholly unprepared for such negotiations, either individually or as a group. Many developing countries had, in any case, liberalized their regime for FDI and considered that they were well served by the current bilateral agreements.

Eventually the developing countries settled for negotiating agreements on four clusters of trade-related investment matters -- Trade-Related Investment Measures (TRIMs), General Agreement on Trade in Services (GATS), Trade-Related Intellectual Property Rights (TRIPs) and the Agreement on Subsidies and Countervailing Measures (ASCM).[1]

In the wake of the UR agreements, the advanced industrial countries of the North continued to promote the idea of a global framework for a fully liberalized global FDI regime and exerted pressures to have the matter included on the WTO's agenda for the immediate future. The majority of developing countries continued to oppose the idea, as also proposals that the issue should initially be one for study in the WTO. If studies were to be undertaken, developing countries regarded UNCTAD to be the more appropriate institution to carry out, mobilize and coordinate such policy-oriented research work and provide the forum for discussions on the objectives and content of a possible FDI agreement. The reason was because UNCTAD is considered a development oriented institution and a global forum

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[1] The GATS involves FDI matters since many services can only be provided by the establishment of a local subsidiary by a foreign service provider. The particular significance of GATS for any future discussion on multilateral investment rules and standards is that its central features suggest that a development-oriented approach to FDI is possible. The TRIPs agreement has a bearing on FDI matters in that the definition of these rights and the adherence to international standards and procedures provides the framework within which foreign investment takes place. The TRIPs agreement poses a number of very significant problems for developing countries and many economists, including leading students of the subject in the North, suggest that the TRIPs agreement is on balance likely to be inimical to economic development in the South. See for example Scherer, 1996; Deardorf 1992. With respect to the ASCM, certain investment incentives fit within the definition of a subsidy and as such are prohibited and subject to multilateral disciplines.

facilitating the participation of all developing countries and which can be conducive to a full and free exchange of views by all**.**

In the event, the 1996 WTO Singapore Ministerial meeting reached the following compromise :

> "Having regard to the existing WTO provisions on matters related to investment and competition policy and the built-in agenda in these areas, including under the TRIMs Agreement, and on the understanding that the work undertaken shall not prejudge whether negotiations will be initiated in the future, we also agree to:
>
> - establish a working group to examine the relationship between trade and investment; and
>
> - establish a working group to study issues raised by Members relating to the interaction between trade and competition policy, including anti-competitive practices, in order to identify any areas that may merit further consideration in the WTO framework.
>
> These groups shall draw upon each other's work if necessary and also draw upon and be without prejudice to the work in UNCTAD and other appropriate intergovernmental forums. As regards UNCTAD, we welcome the work under way as provided for in the Midrand Declaration and the contribution it can make to the understanding of issues. In the conduct of the working groups, we encourage co-operation with the above organizations to make the best use of available resources and to ensure that the development dimension is taken fully into account. The General Council will keep the work of each body under review, and will determine after two years how the work of each body should proceed. It is clearly understood that future negotiations, if any, regarding multilateral disciplines in these areas will take place only after an explicit consensus is taken among WTO members regarding such negotiations." (WTO, 1996a.)

As a result of this Singapore decision and the earlier UNCTAD Midrand decision, developing countries face the need to prepare and coordinate their views concerning the issues on the UNCTAD and WTO agendas.[2]

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[2] "The UNCTAD Midrand conference agreed, among other things, that UNCTAD should provide a forum for:

In the meantime, the countries of the North are negotiating within OECD a comprehensive investment agreement among themselves -- the major host and home countries for FDI. Briefly, the declared objective is to establish a free-standing treaty which subjects foreign investment to a multilaterally agreed regime which removes all or most of the remaining restrictions on such investment and ensures that FDI is treated by national authorities no differently from domestic investment. There is consensus within the OECD on a single broad definition of investment, which goes "beyond the traditional notion of FDI to cover virtually all tangible and intangible assets, and which applies to both pre-establishment and post-establishment" (OECD, 1997). The definition therefore embraces intellectual property and portfolio investment. More specifically, from available documentation and commentaries, the proposed regime is likely to be based on the following principles.[3]

- the right of establishment for foreign investors;
- the principle of "most favoured nation" (mfn) treatment;
- the principle of "national treatment";
- investment protection, including matters relating to expropriation, transfer of capital;
- additional disciplines relating to, among other matters:
  - entry, stay and work of key personnel;
  - performance requirements imposed by host governments on foreign investors in order to secure economic benefits for the country as a whole;
- binding rules for settling disputes;
- rules on investment incentives.[4]

The intention is to keep to a minimum any general exceptions, temporary derogations and country specific reservations, which will be subject to standstill and phasing-out rules.

It was intended that the OECD agreement (referred to as the OECD MAI) be completed in May 1997, but certain difficulties are delaying the process. However, few doubt that it will be concluded,

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"Improving general understanding of trends and changes in foreign-direct-investment (FDI) flows and related policies, the interrelationships between FDI, trade, technology and development, and issues related to transnational corporations of all sizes and their contribution to development, … ."
"Identifying and analysing implications for development of issues relevant to a possible multilateral framework on investment, beginning with an examination and review of existing agreements, taking into account the interests of developing countries." (UNCTAD, May 1996)

[3] For example, European Commission, COM (95) 42; OECD, 1995; OECD, 1996a; OECD 1996b; OECD, 1996c; OECD, 1997.

[4] OECD countries are concerned that they are engaged in costly competition with one another in offering investment incentives. However, to date, beyond broad agreement that the obligations of national treatment and mfn treatment should apply to investment incentives, there is no consensus on what additional disciplines, if any, should be imposed on non-discriminatory investment incentives. It has been proposed that the issue of additional disciplines on investment incentives be dealt with in negotiations to take place after the entry into force of the MAI.

even if belatedly, with the more controversial matters possible being left to a later stage, creating what is akin to an "in-built" agenda on matters such as investment incentives and taxation matters. This presents a major policy challenge to developing countries. The challenge is all the more complex because the OECD envisages the possibility that some non-OECD countries (whose open, liberal investment policies on investment are conducive to making them "willing and able" to meeting the MAI obligations) may become "original Contracting Parties of the MAI", completing the negotiations on this matter before the OECD contracting parties ratify the MAI. All developing countries, however, are to be "offered the opportunity" to accede to the MAI, once it has been negotiated and ratified by advanced industrial countries. It is important to emphasize, however, that the basic provisions of the Agreement will not be open to re-negotiation by the individual developing countries willing to join: they will only be able to negotiate the conditions of their acceptance, registering, for example, national reservations.

In the situation in which the OECD agreement, in one form or another, is likely soon to see the light of day, and in which certain global rules on FDI matters are scheduled for discussion in UNCTAD as well as in WTO, there is a need for careful assessment by developing countries of their position on the matter of global rules for FDI. The task is complicated by the fact that there is an overlap of agendas of the OECD, WTO and UNCTAD with respect to these matters.[5]

B. The purpose of this document

The purpose of this policy brief is to contribute to developing countries' assessment of the above situation which could have a profound impact on them individually and collectively.

This is not an easy task in view of the current intellectual and political climate which has effected a change in the attitude of a number of governments and institutions, both in the North and in the South, to the extent that they now seem to consider FDI to be an unmitigated benefit under all circumstances.

Academic economists have always recognised that just as there are benefits of FDI (notably technology transfer, augmentation of the host country's investment resources), there may also be significant costs. The latter would include, among other things, the burden of the future dividend payments on the country's balance of payments, the effects of the exercise of market power, or transfer pricing by the multinationals. Indeed much economic research on the subject in the 1950s and 1960s

[5] It is essential to distinguish between the Multilateral Agreement on Investment (MAI) currently being negotiated between members of the OECD and MIA – multilateral agreement on investment -- which was and continues to be the way of referring to a hypothetical WTO agreement on FDI matters. A new

regarded the net outcome of FDI to be more often negative than positive unless it was carefully regulated.

However, in the 1970s and the 1980s the pendulum has swung the other way and there now seems to be a presumption that the net result of any FDI will always be positive. While academic economists still tend to be balanced in their approach to the subject, a number of economists, particularly in the international financial institutions, seem to have been swept along by enthusiasm for liberalization and globalization, uncritically accepting the tenets of neo-liberal market philosophy, and presenting FDI as an important vehicle through which, among other things, the benefits of liberalization and globalization accrue to developing as well as developed countries.

It is thus argued that a global investment regime will lead not only to greater, but, more significantly, to *deeper* integration of the world economy from which both the North and the South will benefit. Integration through FDI is thought to be qualitatively different from that achieved by trade or portfolio capital flows, in that it involves direct integration of production in various countries. It is further suggested that this greater and deeper integration not only leads to faster economic growth world wide, but also in principle to convergence in living standards in different countries. A multilateral investment agreement of the sort proposed by the OECD, it is argued, will contribute to this process by leading to greater overall FDI than would otherwise be the case. On current trends, developing countries, it is suggested, will increasingly be the beneficiaries of the larger FDI flows.[6]

In addition to the systemic benefits arising from deep integration of the world economy, the proponents of MAI suggest that FDI is the best form in which developing countries can receive capital inflows to assist their economic development and further their economic growth.

Such arguments need careful consideration and critical analysis. In attempting this, the document examines a number of important basic issues -- including key facts, conceptual issues and related matters -- regarding FDI which should be taken into account by developing countries when considering their national policy on FDI and when discussing the merits of, or need for, free access for FDI of the kind being negotiated in the OECD, which previously was mooted as a model for a possible WTO treaty on the matter.

The document also outlines an approach for the South in the evolving scenario and sketches out the desirable characteristics of a development-friendly multilateral arrangement which would serve the development interests of the countries of the South, and at the same time meet the legitimate interests of the North and multinationals of both North and South.

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terminology is now emerging, whereby FAI (framework agreement on investment) is referred to rather than MIA.

[6] See further, IMF, 1997; World Bank 1996; Sachs and Warner, 1995.

Part II. Foreign Direct Investment: Facts, Conceptual Issues and Costs and Benefits for Developing Countries

A. The Broad Facts

In order to put the analytical discussion on the role of FDI in development into perspective, it is first necessary to set out and examine the broad facts.[7] The most relevant of these, from the perspective of developing countries, are as follows.

1. Total FDI inflows

As Table 1 indicates, during the last 15 years there has been a huge increase in FDI flows in the world economy, reflecting, and contributing to, its greater integration. Total FDI inflows to all countries rose from an average of US$ 50 billion a year in the period 1981-1985 to an average of US$155 billion between 1986-1990, to a little over US$ 200 billion in 1993, and to US$ 212.5 billion in 1994. FDI to developing countries rose six-fold over the period 1981-1994, while that to developed countries, starting from a higher base, increased by about three and a half times.

Overall in 1994, roughly 40 per cent of FDI inflows went to the developing countries, almost 3 per cent to economies in transition and the remainder -- just less than 60 per cent -- to developed countries.

UNCTAD has recently provided data which bring up to date the aggregate figures for FDI inflows. (UNCTAD, 10 July 1997 -- press release). The organization reports that global FDI inflows rose by 10 per cent in 1996 to US$ 349 billion. It is noted that although the growth rate of overall FDI fell significantly in 1996 compared with 1995 when total inflows rose by 33 per cent, nevertheless the inflows have been increasing every year since 1992. However, because inflows into developed countries were virtually stagnant in 1996 compared with 1995, most of the growth took place in developing countries. These countries recorded an increase of nearly a third in 1996 compared with 1995, with their share of total FDI inflows rising from 30 per cent in 1995 to 37 per cent in 1996.

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[7] There are certain technical features of the definition of FDI which make measured FDI different from its common sense meaning. These are discussed below in relation to analytical issues on which they have a significant bearing. However, these do not affect the broad aggregate trends described in this subsection.

Table 1.

FDI inflows and stock in developing countries, 1981-94

Region	Annual average inflow 1981-85	1986-90	1991-94	Inflow 1993	Inflow 1994[a/]	Stock 1994
Developing countries[b/]						
Value ($billion)	13.1	25.3	63.4	73.4	84.4	584.0
Share of the world total (%)	25.9	16.0	33.3	35.2	37.4	25.2
Africa						
Value ($billion)	1.7	2.8	3.1	2.9	3.1	64.1
Share of the world total (%)	3.4	1.8	1.6	1.4	1.4	2.8
Share of developing-country total (%)	12.9	11.2	4.9	4.1	3.6	10.9
Latin America and the Caribbean						
Value ($billion)	5.9	6.0	18.3	19.9	20.3	186.2
Share of the world total (%)	11.6	5.1	9.6	9.5	9.0	8.0
Share of developing-country total (%)	44.7	31.7	29.0	27.1	24.1	31.3
Asia						
Value ($billion)	0.4	0.4	1.4	1.3	1.4	34.5
Share of the world total (%)	0.9	0.3	0.7	0.6	0.6	1.5
Share of developing-country total (%)	3.4	1.7	2.2	1.8	1.7	5.8
East, South and South-East Asia						
Value ($billion)	4.9	13.8	40.0	48.5	59.1	305.1
Share of the world total (%)	9.8	6.7	20.1	23.3	26.2	13.2
Share of developing-country total (%)	37.6	54.4	63.2	66.0	70.0	51.2
The Pacific						
Value ($billion)	0.1	0.2	0.3	0.3	0.3	2.7
Share of the world total (%)	0.3	0.1	0.2	0.1	0.1	0.1
Share of developing-country total (%)	1.1	0.7	0.5	0.4	0.4	0.5

Memorandum:						
Least developed countries						
Value ($billion)	0.2	0.5	0.9	0.8	0.9	10.6
Share of the world total (%)	0.4	0.4	0.5	0.4	0.4	0.5
Share of developing-country total (%)	1.4	2.3	1.4	1.1	1.0	1.8
Developing countries excluding China						
Value ($billion)	12.3	22.4	44.0	45.8	50.6	491.6
Share of the world total (%)	24.3	14.2	23.1	22.0	22.4	21.2
Share of developing-country total (%)	93.9	88.6	70.0	62.4	60.0	82.6

Source: UNIDO, The Globalization of Industry; Implications for Developing Countries Beyond 2000. UNIDO, Vienna, December 1996.

a/ Estimate

b/ Includes industrially less developed countries in Europe (Gibraltar, Malta and the former Yugoslavia)

FDI surges

From the perspective of the South, an important aspect to register with respect to FDI inflows is the question of surges. Table 1 indicates that the level of FDI inflows into developing countries almost doubled in the period 1986-90 compared with 1981-85. Between 1992 and 1993 FDI rose by 49 per cent (from US$ 48.9 billion to US$ 73.0 billion). As seen above from UNCTAD's latest figures, there was a further big increase of 33 per cent between 1995 and 1996 in the FDI inflows into developing countries. Such surges would tend to be even greater in magnitude for some individual countries than for developing countries as a whole, since FDI inflows are far from evenly distributed. Surges can be highly destabilizing, as they often affect the exchange rate and through that the equilibrium of other important macro-economic variables, as will be seen later.

2. Regional and country concentration of inflows

Regional concentration of developing country inflows

The main developing country recipients of FDI inflows were in Asia, followed by Latin America. Africa received only 2.8 per cent of total FDI inflows in 1994. (See Table 1.) Within this broad pattern there is a very high degree of country concentration of inflows, with ten developing countries accounting for 77 per cent of the total of such inflows in 1995.[8] (See Table 2.) China has been by far the largest single developing country recipient of FDI in recent years.[9]

Developed and developing country ranking with respect to inflows

Table 3 below, covering developing and developed countries, shows that between 1985 and 1995 the United States was the largest recipient of the cumulative inflows over these 10 years, followed by the UK, France and China. Indeed an outstanding feature of foreign investment flows during this last part of the century has been the huge increase in FDI inflows to the United States. (In 1970, the stock of FDI in the US amounted to 17.5 per cent of the total stock of US direct investment abroad. By 1989 this figure had increased to 96.5 per cent.) Seven developing countries, however, were among the top 20 recipients of total world FDI inflows.

However, if FDI is considered on a per capita basis (see Table 3, last two columns) the rankings are greatly changed, as would be expected. The US drops from first to thirteenth place, China from fourth to twentieth, and Singapore becomes the world's leading recipient of FDI per capita in the period 1985-95.

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[8] The appearance of Bermuda among the top ten developing country recipients of FDI flows points to some of the difficulties with FDI statistics. The Financial Times (14 July 1997) reported that Roche, the Swiss pharmaceutical drugs group had lately bought Boehringer-Mannheim, a German diagnostics and pharmaceuticals company for US $ 11 billion. However, as the Financial Times notes, the Swiss investment will not appear in Germany's FDI inflow statistics for 1997 but rather will be recorded as a Swiss investment in Bermuda. This is because Roche was in fact buying the Bermuda-registered holding company which owned the German company. See Norman, 1997.

[9] There is some suggestion that the Chinese FDI is overstated in that it includes some "round-tripping" of Chinese domestic capital through Hong Kong in order to benefit from the special incentives which the Chinese government provides to encourage investment from abroad. *The Economist* (1 March 1997, page 72) reported that many of these incentives are now being withdrawn, partly in response to complaints from Chinese domestic companies. This will reduce the extent of "round-tripping" which, in any case, is regarded as being relatively quite small.

Table 2

Average annual inflows of FDI to the 10 largest recipients among developing countries

(millions of US dollars and percentages)

Host	**1984-1989**	**Host**	**1993**	**Host**	**1995**
Mexico	2436	China	27515	China	37500
China	2282	Argentina	6305	Mexico	6984
Singapore	2239	Singapore	5016	Malaysia	5800
Hong Kong	1422	Malaysia	5006	Singapore	5302
Brazil	1416	Mexico	4389	Brazil	4859
Bermuda	1144	Bermuda	2960	Indonesia	4500
Egypt	1085	Indonesia	2004	Argentina	3900
Saudi Arabia	1084	Thailand	1726	Chile	3021
Malaysia	798	Hong Kong	1667	Bermuda	2900
Argentina	653	Saudi Arabia	1369	Thailand	2300
Share of top ten in total flows to developing	66%	Share of top ten in total flows to developing	79%	Share of top ten in total flows to developing	77%

Source: UNCTAD (1996a) *World Investment Report, 1996*, Annex table 1.

Table 3

Leading host economies for FDI based on cumulative inflows

1985-95

Rank	Country	FDI billion $	FDI Per Capita ($)	FDI Ranking
1	**United States**	477.5	1820	13
2	**United Kingdom**	199.6	3410	7
3	**France**	138.0	2380	10
4	**China**	130.2	110	20
5	**Spain**	90.9	2320	11
6	**Belgium-Luxembourg**	72.4	6900	2
7	**Netherlands**	68.1	4410	3
8	**Australia**	62.6	3470	6
9	**Canada**	60.9	2060	12
10	Mexico	44.1	470	17
11	**Singapore**	40.8	13650	1
12	**Sweden**	37.7	4270	4
13	**Italy**	36.3	630	16
14	Malaysia	30.7	1520	14
15	**Germany**	25.9	320	18
16	**Switzerland**	25.2	3580	5
17	Argentina	23.5	680	15
18	Brazil	20.3	130	19
19	**Hong Kong**	17.9	2890	9
20	**Denmark**	15.7	3000	8

Note: Economies in bold are also among the 20 leading *home* economies for FDI (note that definitions of FDI vary considerably across the economies). Excluding Bermuda, for which cumulated FDI inflows, largely in the financial sector, amount to US$ 21.5 billion.

Source: WTO (1996b) *Annual Report 1996, Vol. 1, Trade and Foreign Direct Investment*, Table IV.1, Geneva 1996.

3. Total FDI outflows and their concentration

The previous tables have focused on FDI inflows. It is however also important to consider the changing characteristics of FDI outflows. In nominal terms total world outflows of FDI rose from just under US$ 13 billion in 1970 to US$ 186 billion in 1993.[10] According to the latest data made available by UNCTAD, the 1996 figure for total world FDI outflows was US$ 347 billion. Even correcting for inflation, this rise in outflows over the period represents a very substantial increase.

The outflows of FDI are even more highly concentrated than inflows. In 1970, 91 per cent of total world FDI outflows originated in seven countries (US, Japan, Germany, France, Italy, UK and Canada, in that order). Of the total outflows, the USA provided 60 per cent, while the total for all industrialized countries was 99 per cent. By 1993, the latter's share had fallen to 94 per cent, the remaining 6 per cent represented FDI by developing countries largely in Asia. The Group of 7 (G-7) advanced industrial countries' share had fallen to 79 per cent, and that of the United States had nearly halved to 31 per cent. (Graham, 1995, p.123) However, UNCTAD's latest data show that in 1996 the developing countries' share (US$ 51 billion) of global FDI outflows had risen to 15 per cent of the total.

4. FDI outflows and inflows among developing countries

Outward FDI flows from developing countries

An important development in the last 15 years has been the growth of outward FDI from a small number of developing countries, as indicated in Table 4. The most notable growth rates are for Hong Kong, Taiwan Province of China and China.

The destination of developing country outward FDI flows

In the early period of outward FDI from developing countries the bulk was concentrated in developing countries. However, as developing countries' exports to industrial countries increased over time, their FDI outward flows to these countries also increased. Such flows are certainly partly dictated by developing countries' need to improve their competitiveness. As the products they export become technologically more sophisticated, investment is required in complementary services and promotion. Nevertheless, for many developing countries a significant, if not major, proportion of their FDI inflows comes from other developing countries. In 1990, nearly two thirds of China's inward FDI stock came from other developing countries. The corresponding figures are nearly 50 per cent for Sri Lanka, 40

[10] Inflow figures for all countries for 1993 were about US$ 200 billion. If inflows and outflows were properly measured they should be equal for the world as a whole. See discussion below.

per cent for Malaysia and nearly 30 per cent for Indonesia and Taiwan. In Latin America, 37 per cent of inward FDI stock in Paraguay and nearly 30 per cent in Chile came from other developing countries, as did over 25 per cent in Uruguay and Ecuador. (UNCTAD, 1992 and UNCTAD, 1994.)

Table 4

Stock of Outward FDI of Selected Developing Countries

1980 -1995 [a]

Millions of dollars

	1980	1985	1990	1995 [b]
Hong Kong	148	2345	13242	85156
Taiwan, Province of China	97	204	12888	24344
China	--	131	2489	17268
Singapore	652	1320	4741	13842
Nigeria	--	5334	9652	11582
South Korea	142	526	2095	11079
Malaysia	414	749	2283	8903
Kuwait	568	930	3663	7655
Brazil	652	1361	2397	6460
Panama	811	2204	4188	4487

[a] The top ten developing countries by size of outward FDI stock in 1995.

[b] Estimates

-- Not available

Source: UNCTAD (1996a) *World Investment Report, 1996*, Annex table 4.

Table 5

Industrialized Countries' Share in Outward FDI Stock

of Developing Countries, 1980/1991

Home Country	Industrialized Countries' share	
	1980	1991
China	34	71
Hong-Kong	8	18
India	11	19
Singapore	9	21
South Korea	32	56

Source: Kumar, 1995.

B. The definition and measurement of FDI: conceptual and practical issues

1. The definition of FDI

The commonly used statistics on FDI -- which to a greater or lesser extent are based on guidelines established by the IMF (International Monetary Fund) -- raise important conceptual questions regarding definition and interpretation, as well as practical problems of measurement.

FDI, (*****according to IMF conventions (?)***, comprises three components:

a) new equity or debt flows from the parent company in the home country to the subsidiary in the host country;

b) profits of the subsidiary; and

c) changes in the value of the paid-in capital and the reserves of the subsidiary.

There are a number of implications of this definition as a basis for measuring FDI to which it is important to draw attention.

2. Conceptual issues

Beginning with conceptual matters, it is important to recognize that FDI defined and measured in the above fashion does not necessarily mean that an actual act of investment as commonly understood has occurred. In other words, an increase in measured FDI does not necessarily signify that an expenditure has been incurred to increase plant and machinery or stocks. Indeed, from the point of view of the subsidiary in the host country, FDI defined in the manner described above is a *source* of capital funds but not a *use* of funds. This is for the following reasons.

First, recorded inflows of new equity or debt into the host country may be destined for the purpose of buying up an existing firm or merging with one, though counted as FDI in the statistics, does not necessarily represent any immediate addition to plant and machinery or stocks.

Second, the profits of a subsidiary in a host country, whether these are repatriated or not, are notionally regarded as an outflow in the current account of the host country's balance of payments. At the same time, that portion of undistributed profits (i.e. profits which are not distributed to shareholders as dividends) which remain in the host country is regarded as an inflow of FDI from the home country to the host country and recorded as a notional inflow on the capital account of the host country's balance of payments.[11] However, a subsidiary in a host country may use undistributed profits to buy financial assets or loan them to another enterprise for any use whatsoever and there will therefore have been no net addition to capital stock or inventories of the subsidiary or of the nation. Furthermore, a subsidiary firm may earn no profits whatsoever in a particular year but borrow funds in the host country in order to invest in plant and machinery or to finance an increase in stocks. Such an act of investment is not, however, recorded in the FDI statistics, due to the fact that it is not recorded as a balance of payments transaction.

Thirdly, a change in the value of the paid-in capital or the reserves of the subsidiary do not necessarily change the level of physical investment.

3. Practical difficulties in measurement

There are serious practical difficulties in the compilation of FDI data, particularly in the case of developing countries where governments do not always have the necessary machinery to collect such statistics on a systematic basis. For this reason, UNCTAD's 1995 World Investment Report (UNCTAD, 1995a) relied on data provided by the home countries rather than on host country information.

Furthermore, ***even*** countries which do have adequate statistics gathering machinery -- mainly the advanced countries -- have difficulties. These arise from the fact that they each have different accounting conventions, statistical apparatus and procedures, definitions and concepts which means that only a very few of them fully follow the IMF guidelines on FDI measurement in all their details.

Another problem arises in relation to the consistent measurement of FDI internationally. This is due to the fact that a distinction has to be made between FDI and portfolio investment. As WTO (1996b) notes "Foreign direct investment (FDI) occurs when an investor based in one country (the home country) acquires an asset in another country (the host country) *with the intent to manage that asset*. The management dimension is what distinguishes FDI from portfolio investment in foreign stocks, bonds and other financial instruments." Different countries, however, adopt different conventions in this respect. For example, some may regard foreign ownership of 20 per cent in an enterprise as constituting "control", while others may consider 50 per cent or more as signifying "control".

In view of the above problems, it is not surprising that the FDI statistics of most countries, but particularly the developing ones, are subject to considerable errors and omissions. World FDI inflows and outflows do not match -- often by a considerable margin. Moreover, the practical problems referred

[11] Profits distributed to shareholders in the host country are not recorded as a balance of payments item

above create difficulties for inter-country and international comparisons of FDI data at any one point in time and may also lead to biases in comparisons over time.

4 Substantive implications

Apart from these measurement difficulties with regard to FDI statistics, there are substantive economic implications which arise from this way of defining and measuring FDI. It is important to note, for example, that data for the United States shows that the capital expenditure of US subsidiaries abroad is invariably greater than the recorded US FDI outflows. This indicates that US subsidiaries are raising significant sums of finance in the host countries for their local investment needs. This is probably the case with other advanced countries as well, but there is no data to substantiate the fact. (Graham, 1995.)

As will be seen from the discussion of the balance of payments issue below, certain components of FDI as conventionally defined -- profit remittances and retained profits *as well as* new equity or debt inflows -- have important economic consequences for the real economy due to their volatility and to the nature of their relationship to economic cycles, that is, whether inflows of these FDI components increase when the country is in economic difficulties and decrease when it is doing well, (in other words, whether they are counter-cyclical) or the reverse (pro-cyclical).

In what follows and in order to illustrate particular points, a more straightforward and conventional definition of FDI will be used, in which it is considered as a source of funds to create new productive assets.

C. The determinants of FDI: theoretical approaches and practical reasons

1. Micro-level theories

What determines whether a firm decides to establish production facilities abroad rather than export its product or licence overseas entrepreneurs to produce instead? A common sense answer might be that it is primarily lower labour costs which induces firms to invest abroad. However, although the differences in labour costs may sometimes help influence firms' decisions to locate abroad, they are far from being the whole story. As the FDI data in the previous section showed, the majority of FDI still goes to the advanced countries, in particular the United States where wages are high relative to those in developing countries.

Economists have long recognized that there will normally be extra costs involved at least initially for a firm investing in a foreign country where it is not familiar with local markets and institutions. At a theoretical level, economic analysis offers three main explanatory approaches which

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and do not feature in the FDI statistics, as would be expected.

attempt to show why, despite these disadvantages, firms may still wish to invest abroad. These approaches focus on different aspects, namely:

- *ownership advantages*: (Hymer, 1960) such advantages are thought to arise from economies of scale with respect to intangible assets such as skilled management capacity or organizational know-how which may also be exploited to even greater advantage by investing abroad.

- *locational advantages*: (Vernon, 1966) these arise in part from the fact that, for many products, there is a production cycle involving several stages, with new technology first being produced and used in the home country and, once standardized, shifted abroad because either nearness to the final market or lower factor costs make this advantageous. However, even if one were to accept the characterization of technological stages in this theory, the theory does not explain why a firm has to establish its presence abroad rather than licence its technology or products.

- *internalization advantages*: Buckley and Casson (1976) attempted to fill the gap in the locational advantages theories by calling attention to advantages which may accrue to a firm from "internalization", i.e. engaging in foreign production itself, rather than sub-contracting or licensing it to a foreign firm. These authors drew on the general “transactions costs” theory of Williamson (1975) which provides a rationale to explain why it may be more advantageous to concentrate certain activities within the firm, rather than rely on the market mechanism to achieve the same objectives, say, by licensing or sub-contracting. The basic idea here is that there are transactions costs of various kinds involved in operating through the market mechanism. When such costs are greater than those arising from carrying out activities within the firm, internalization, that is, establishing an overseas subsidiary will be preferred.

These mainstream theoretical approaches are not mutually exclusive; nor are they comprehensive. They do however encompass most of the practical reasons why firms may invest abroad, for example, access to markets, labour costs, proximity to raw materials, a more lax approach to the environment, and fiscal incentives. There are, however, other theories which explain multinational investment in rather different terms, such as oligopolistic rivalry between firms at the global level, the empire-building motives of managers of large corporations in advanced countries, or strategic entry deterrence, that is, the build-up of overseas capacity in order to stop potential rivals from entering any specific market or markets.[12] Such theories may be better than the mainstream theories in explaining some of the observed facts concerning FDI, notably the existence of FDI surges.

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[12] For a recent review of such theories, see Pitelis, 1996. Oligopolistic rivalry refers to rivalry in a market which is shared by a small number of usually large producers or sellers. Each producer is thereby obliged in its market behaviour to take fully into account the actions and behaviour of its current and potential large rivals in the market.

2. Macro-level explanations

In addition to these micro-economic theories of FDI, there is an older literature which contains macro-level theoretical approaches and "broad-brush" accounts which attempt to explain why foreign investment takes places. These include various theories of economic imperialism, based on different interpretations of the workings of the capitalist system. Some are simple "rate of profit" theories which can quite easily be accommodated within the neo-liberal framework sustaining the idea of unfettered flows of capital on a global level. Others which focus on the "vent for surplus" have greater political content in that capital export is seen as a necessity under certain (low) wage conditions and some of these theories predict a cataclysmic end to the capitalist system.

Governments, too, -- particularly of the rich advanced countries -- make substantial efforts to encourage overseas investment by their enterprises, with a view to increasing potential exports of capital goods (including military equipment), while at the same time generating inflows of profit remittances benefiting the balance of payments. Such efforts sometimes correspond to a geopolitical strategy to "tame" through indirect influence the policies of governments in countries with the actual or potential political and economic power to exert a regional or global influence.

3. The present situation: "oligopolistic disequilibrium" in the world economy

The recent upsurge in FDI in the world economy is most likely explained by global factors, specifically liberalization in both advanced and developing countries, as well as slower world economic growth. In advanced countries, there has been, among other things, the completion of a Single European Market. In developing countries there has been trade and financial liberalization in Africa and Latin America as well as in Asia. (In Africa and Latin America these were ushered in many cases through the structural adjustment policies introduced to deal with the debt crisis.) Together with slower world economic growth, this has led to much greater competitive pressure among multinationals as well as greater opportunities to reap locational advantages. The greater competition and cost cutting in turn has led to attempts to re-establish market power through strategic alliances between multinationals, joint ventures and collaboration over R&D. In other words, the present situation is one of oligopolistic disequilibrium in many product markets in which the leading participants are attempting to maintain or improve on their market share through takeovers and alliances until a new oligopolistic equilibrium is reached.[13] The result of these processes is that there has been a big increase in FDI, even while the rate of total investment (national and FDI) has not increased or may even have declined. This market situation poses particular dangers for developing country firms. These tend to be smaller and therefore, even

[13] This is one reason why FDI is taking the form of mergers and acquisitions, particularly in advanced countries. According to UNCTAD (10 July 1997) "The value of cross-border mergers and acquisitions, including minority-held transactions classified as portfolio investments, reached a record of US$ 275 billion, or 79 per cent of global FDI inflows, in 1996. Majority-held transactions alone were worth US$ 163 billion, or 47 per cent of global inflows." See also the UNCTAD World Investment Report 1995 and 1996 for information on cross-border take-overs and strategic alliances.

when efficient, are vulnerable to takeovers by the much less efficient larger multinationals. These developments raise questions of competition policy and level playing fields, a situation which would become more acute with an MAI.

For the purposes of this document, however, what is more important is not so much the investors' reasons for any act of foreign investment, but the consequences for an individual host country of specific FDI projects or of gross and net FDI flows. It is this set of issues -- one which is the subject of some considerable dispute -- that requires more detailed examination.

D. Costs and benefits of FDI

The central question for developing countries is what are the costs and benefits of FDI? The traditional literature has recognised the following benefits and costs.

1. Theoretical costs and benefits of FDI

As noted before, the academic literature on FDI fully recognizes that, from the point of view of host developing countries, there are both important benefits and possibly significant costs associated with FDI. The possible benefits include the transfer of technology to individual firms and technological spill-over to the wider economy; increased productive efficiency due to competition from multinational subsidiaries; improvement in the quality of the factors of production including management in other firms and not just the host firm; benefits to the balance of payments through the inflow of investment funds; increases in exports; increases in savings and investment, and hence faster growth of output and employment. Consumers may benefit both from lower prices of goods and the introduction of new or better quality goods.

Among the acknowledged costs are the possible negative effects on the balance of payments due, for example, to an increase in the import of inputs by subsidiaries and to payments of dividends and royalties abroad. Moreover, to the extent that multinationals exercise considerable market power, not only do the direct costs of non-competitive pricing have to be considered, but it is also necessary to take into account the overall inefficiency in the allocation of resources to which such pricing behaviour leads. In view of the large absolute size of many multinationals, the question of their impact on the competitive environment also becomes critical.[14]

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[14] Modern economic theory suggests that even markets which are dominated by oligopolistic or monopolistic firms may produce outcomes similar to those of competitive markets, provided that they are contestable in the sense that they are open to challenge by new entrants. However, this theory is only valid under some very restrictive assumptions, which normally do not obtain in the real world. The classic article on this subject is Baumol, 1982.

Although, as noted above, FDI may have wider technological benefits through its spill-over effects, it could also discourage the development of technical know-how by and in local firms and institutions, to the detriment of the growth of domestic producers and the national economy. If it fails to generate adequate linkages with the local economy, FDI will have fewer beneficial spill-over effects and may, on balance, be harmful if one or more of the negative features outlined below are also present.[15]

Among other factors on the cost side, the following may also be important: transfer pricing, which, among other things, diminishes the tax revenues going to host governments; the cache of brands names attached to the output of subsidiaries and the associated advertising may give rise to economically and socially distorting consumption patterns. Sometimes, such distortions can have a far-reaching detrimental impact, such as when more costly foreign foods produced under FDI supplant local and more nutritious contributions to the diet of poor urban consumers in particular. There may be social costs in the form of unemployment when FDI, which is relatively capital intensive, causes the more labour intensive local firms to close down, and there is a net loss of jobs.

Environmental and natural resource costs may also be involved, requiring careful calculation of the short-term advantages to be gained from an investment and the longer term implications for the country's resource base and general state of the environment.[16] Other less tangible costs may also arise from FDI. A widely recognized example concerns the detrimental socio-cultural and environmental impact resulting from FDI which brings in substantial numbers of tourists, some of whom may abuse local culture and traditions.

An open market in FDI in the print and TV media and in the entertainments field also poses the risk of facilitating dominance by very different cultures, rather than providing a window on a multicultural world, something which is also a matter of public concern in parts of the North.[17] This is especially a problem in societies in the South where the funds for local production are scarce or non-existent. FDI in the news and entertainment sector also facilitates subtle and widespread political influence, both through the world-view that is conveyed and by the attitudes conveyed towards domestic issues and matters on the political agenda.

Sometimes, and even more importantly, politico-strategic interests are at stake, as when FDI comprises a large component of total investment and decisions made principally abroad may have a

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[15] See the interesting recent literature review by Rodriguez-Clarke (1996) and the references contained therein.

[16] The large-scale exploration and exploitation of natural resources is often associated with large-scale environmental damage. These investments are often carried out by multinationals, though this is not to suggest that national investors would necessarily be any more concerned about the environmental consequences of their activities.

[17] See for example, Huntington, 1996

considerable impact on the local economy and society and, directly or less directly, on socio-economic policy. In some circumstances, even the country's sovereignty may be at stake.

In a situation where foreign investment will benefit one particular ethnic group, there may be extensive and complex ramifications, if this is likely to exacerbate already volatile ethnic relations.

Although economists are prone to ignore such socio-cultural and political considerations, these clearly must comprise part of the overall net evaluation of the costs and benefits of FDI.

It is interesting to note that The South Korean Government's 1981 *White Paper on Foreign Investment,* in presenting the government's approach to FDI matters in some detail (EPB, 1981), listed a number of possible costs as well as benefits of FDI. The document pointed to possible costs such as transfer pricing, restrictions by parent companies on subsidiaries' exports, crowding-out domestic investors in the domestic credit market, allocative inefficiency due to non-competitive market structures, distortion of industrial structure due to the introduction of inappropriate products, among other things.

2. Empirical conclusions regarding the benefits and costs of FDI

In view of the above considerations, it cannot be presumed that the net socio-economic impact of FDI will in all circumstances be positive, in principle each case of FDI will need to be examined on its own merits.

Over the years, there have been many studies of FDI in different industries and countries, covering various time periods, with a view to assessing either a single aspect or several aspects of the impact of FDI on the economy and society. Not unexpectedly, the results are mixed, even within the same specific area of analysis, with some studies pointing to positive and others to negative outcomes.

Efforts to establish what can be concluded overall from the various studies on a particular theme, for example the degree to which there is technology transfer or employment creation consequent on FDI, do not provide clear-cut answers. Moreover, the overall assessment tends to differ according to who has carried it out, reflecting the perspectives and intellectual orientation of the authors. Thus the conclusion of the review of evidence recently published by WTO (1996b) reads as follows:

> "Despite the difficulties associated with the measurement of the efficiency-enhancing effects induced by FDI, let alone with the assessment of the specific channels by which a transfer of technology affects local productivity, the empirical literature offers some important conclusions. First, there appears to be a wide consensus that FDI is an important, perhaps even the most important, channel through which advanced technology is transferred to developing countries. Second, there also seems to be a consensus that

> FDI leads to higher productivity in locally owned firms, particularly in the manufacturing sector. Third, there is evidence that the amount of technology transferred through FDI is influenced by various host industry and host country characteristics. More competitive conditions, higher levels of local investment in fixed capital and education, and less restrictive conditions imposed on affiliates appear to increase the extent of technology transfers."

However, a recent comprehensive review carried out in the Institute of Technology of the United Nations University concludes that:

> "Finally the overall impression emerging from a great variety of experiences across countries in terms of the impact of FDI on different parameters of development is that FDI promises more than it delivers. The diverging experiences of countries with respect to host country gains from MNE entry could probably result from different policy packages adopted by different countries. In that the determination of an optimal package of FDI, technology imports, trade, competition and related policies that help to maximize the host country gains is itself a fruitful area of research." (*sic)* (Kumar, Aug. 1996, p.45)

There is a considerable literature which argues that the characteristics of FDI inflows into Asian developing countries from other developing countries, but particularly from Japan, are more conducive to development than are FDI inflows elsewhere from other industrial countries.[18] The basic thesis is that the East and South-East Asian countries have been following a "flying geese pattern of development" in which FDI plays a central role.[19] As Japan and subsequently other Asian NICs become more industrialized and their real wages rise, they shift their more labour intensive and technologically less sophisticated production to their less developed neighbours where real wages are much lower. FDI is thus connected with a dynamic division of labour in a growing regional economy. The Chinese inward FDI from Hong Kong, Taiwan etc. is thought to be of a similar kind.

UNCTAD's (1996b) empirical investigations into this thesis have found that it is more or less valid. The only serious qualification is that non-Japanese and non-Asian FDI still constitutes a large proportion of total FDI inflows into many Asian developing countries. It has been suggested that US FDI, particularly in the Latin American countries, does not follow the "flying geese" model. It is more motivated by market access considerations than by the desire to promote a dynamic division of labour and is therefore not as conducive to development. (See further Felix, 1995; Sunkel and Mortimore, 1996.)

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[18] See UNCTAD (1996b) and the literature cited therein.

[19] For the classis statement of the "flying geese" thesis, see Kojima's collected papers, 1996. See also Ozawa, 1996.

For the purposes of this paper, yet another detailed empirical review of the past evidence will provide little value-added. Rather, it will be much more useful to consider the present circumstances of the world economy, and to analyse the costs and benefits of FDI in the current and prospective conditions of growing liberalization and globalization with which developing countries are faced today.

E. Should developing countries today welcome all FDI?

As noted above, in recent years there has been what is tantamount to a sea-change in the attitude of developing countries towards FDI. Increasingly, they now welcome all FDI and compete with one another to attract it. There are a number of reasons for this change in attitude.

First, as noted before, important arguments are put forward, particularly by the multilateral financial institutions, that "deep" economic integration of developing countries into the international economy brought about through FDI greatly improves their prospects of higher rates of growth. It is presumed, in addition, that, because of the ostensible systemic benefits of integration into the global economy in the present era of worldwide liberalization and globalization, all FDI is beneficial.

Whether or not developing countries accept this reasoning, many of them face problems with regard to obtaining the levels of financial flows they desire. There has been a marked decline in flows of ODA, as well as of private bank credit in the wake of the debt crisis. Moreover, it has come to be recognized that portfolio investment, despite its initial high promise as a source of foreign capital, often entails a number of problems.[20] FDI is thus deemed to be an important additional source of financial resources which at the same time offers prospects of bringing new technology and creating new jobs.

These systemic contentions, however, raise a number of serious questions. As the analysis below suggests, on balance, an undiscerning policy towards FDI may cause serious long-run economic difficulties, harming a country's development prospects. Indeed, the growing liberalization of FDI and of financial markets, while offering additional opportunities to which much attention is given in the literature and debates on FDI matters, also pose significant new hazards to developing countries. These hazards are often ignored, underestimated or underplayed in the ongoing debates and by international organizations, including the United Nations. This neglect is unwise and risky as far as developing countries are concerned for it can have serious detrimental consequences for the long-term financial viability of their economies. A more balanced and complete assessment is therefore required. The

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[20] These include volatility and the fact that such capital flows are based on the chance to make rapid gains, reflecting reactions to the situation regarding interest rates in advanced countries rather than a response to the economic fundamentals in developing countries. Moreover, owing to the well-known "contagion effect" investors' reactions in one capital market soon spread to others. See further, Singh, 1997a.

discussion that follows thus focuses on these important aspects of FDI which are largely overlooked in the present climate of opinion.

1. Implications for the balance of payments, foreign exchange markets and macroeconomic policy

Balance of payments issues

It is elementary but important to appreciate two central facts: first that FDI is motivated by profit and second that FDI gives rise to dividend and profit payments in foreign exchange over the lifetime of the investment, as well as foreign exchange for direct and indirect import costs, possibly on a continuing basis.[21] As most developing countries are balance of payments constrained during the process of development, these foreign exchange outflows raise troublesome policy questions. Whether or not an individual FDI project or FDI collectively generates sufficient foreign exchange earnings to cover the foreign exchange costs is therefore of considerable policy relevance.

Recently, some specialists in international economics have denied that developing countries are balance of payments constrained and should therefore be concerned with the foreign exchange implications of FDI or other foreign capital inflows.[22] Based on their work a theoretically legitimate but empirically erroneous economic doctrine came to hold sway for a while in the 1990s among the international financial institutions. In its extreme form, the doctrine states that in a world of *free* capital movements, the balance of payments of a country does not matter, that it is a purely statistical number with no economic significance. The underlying theoretical reasoning here is based on the view that the balance of payments statistics are the outcome of the individual savings and investment decisions of millions of individual households and private businesses. Sometimes, these economic agents will in the aggregate save more than they invest, which will be reflected in a surplus on the current account of a country's balance of payments.[23] At other times, the sum of agents' decisions will be the opposite and will manifest itself in a current account deficit. These surpluses and deficits of individual households and businesses will automatically be resolved over time by, for example, financial institutions, without the government needing to take any policy action to deal with the imbalances. Thus, according to this doctrine, the government need not concern itself with the state of the balance of payments. This view is

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[21] In addition to the direct foreign exchange costs such as import of capital equipment for the subsidiary, there may be indirect foreign exchange costs in the form of higher levels of imports in other newly generated activities.

[22] ****PLEASE GIVE REFERENCE Cordon, Max**

[23] This follows from the national income accounting identity. Confined to its essential elements, it states that: $Y = C + I + X - M$, where Y = national income, C = consumption, I = investment, X = exports and M = imports. It follows from this that $[Y - C] - I = X - M$. $Y - C = S$ (savings) by definition, and therefore $S - I = X - M$, the latter $(X - M)$ being the current account surplus (or deficit) on the balance of payments.

based on the fundamental precepts of conventional welfare economics which suggests that, under certain assumptions, if all economic agents seek to maximize their own profits or utility, this will achieve the best possible allocation of economic resources. Any government intervention in these circumstances will simply lead to distortions and reduce national welfare.

However, a number of the implicit assumptions of this theory that the "balance of payments does not matter" do not hold in the real world. The theory assumes that the decisions of individual agents on investment and savings are independent of one another. In the real world these decisions are, and are perceived to be, interdependent. More important, however, from a practical point of view is the fact that this theory was undermined by events, namely the Mexican financial crisis of 1994. It will be recalled that in December 1994 the Mexican government was obliged to float the peso which led to a huge forced devaluation, as financial institutions began to withdraw their portfolio capital from Mexico. This led to a financial crisis of gigantic proportions, which threatened not only Mexico but also the entire international financial system. An unprecedented loan of US$ 50 billion from the IMF was required to resolve this crisis. It is generally agreed that the main reason for the crisis was that, after a point, the financial markets were no longer willing to regard the state of Mexico's balance of payments as a mere irrelevance, but rather perceived it to be an indicator of fundamental economic disequilibrium. Due to financial liberalization, Mexican consumers had gone on a buying spree.[24] The net result was that the foreign exchange inflows were being used to finance imported consumer goods, rather than investment. This contributed to a massive current account deficit, reaching 8 per cent of GDP in 1994, greater than what it was in 1982 at the outset of the debt crisis.[25]

Most economists, including those in the international financial institutions, now accept that the current account position of at least the developing countries is a critical variable which deserves the utmost attention even in a world of free capital movements. This point has been reinforced by the recent financial crises in East Asian countries.

The implications for the current and prospective balance of payments of any FDI project must therefore be carefully considered by developing countries if they are to avoid a future "lost decade". There will be FDI projects for which the balance of payments implications are generally benign. These would include investment in net export generating activities. From a longer-term balance of payments perspective, it would also appear to suggest projects where the foreign investor repatriates low dividends and reinvests most of the profits within the country. If, however, FDI takes place in a non-tradable service industry (for example a supermarket, especially one selling imported goods) and if

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[24] The savings of the Mexican private sector (households and businesses) fell from 15 per cent to 5 per cent of GDP as a result of the buying spree.

[25] See Singh, 1997b and Taylor, 1996. For somewhat different interpretations, see the IMF, 1997 and Turner, 1995.

most profits are repatriated, the balance of payments implications, other things being equal, will be inimical to a country's future development prospects.

FDI volatility

In addition to the short and longer-term balance of payments implications of specific FDI projects, similar concerns also arise in relation to aggregate flows of FDI and the stock of FDI. The conventional wisdom is that the stock and flows of FDI are generally a stable form of foreign longer-term capital inflows because they involve "bricks and mortar" and therefore, unlike portfolio investment, require a longer-term commitment on the part of the investor. This wisdom has, however, become doubtful in the context of liberalized financial markets involving, among other things, the introduction of new financial instruments such as derivatives, and the expansion of existing ones, as for example hedging. These developments have greatly blurred the distinction between FDI and portfolio investment with respect to the relative stability of these flows. A World Bank study explicitly acknowledges this point:

> "Because direct investors hold factories and other assets that are impossible to move, it is sometimes assumed that a direct investment inflow is more stable than other forms of capital flows. This need not be the case. While a direct investor usually has some immovable assets, there is no reason in principle why these cannot be fully offset by domestic liabilities. Clearly, a direct investor can borrow in order to export capital, and thereby generate rapid capital outflows."[26]

There are, however, other important reasons why FDI flows may be as volatile as portfolio investment. As noted earlier, profit remittances and profits retained by the subsidiary in the host country are significant components of FDI flows.[27] These are highly volatile and indeed can be just as volatile as portfolio investment flows, especially during an economic crisis. In specific instances, the volatility of profit remittances may come to dominate the degree of fluctuation of total FDI flows. Moreover, to the extent that some of the recorded FDI may represent profits reinvested in portfolio or other assets, these can be liquidated and shifted abroad relatively quickly in response to changes in local interest and exchange rates and economic and political uncertainty. Therefore the old presumption that FDI flows are less volatile than portfolio investment may no longer hold.[28]

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[26] Claessens et. al. 1993, p. 22, quoted in Kregel, J. A.,1996.

[27] In balance of payments accounting terms, profit remittances are first recorded as a current account outflow and then as a capital account inflow.

[28] The World Bank study (Claessens et. al. 1993, p. 26) points out that "long-term flows are often as volatile as short-term flows, and the time it takes for an unexpected shock to a flow to die out is similar across flows." This study suggests that, in general, it is not possible to distinguish between FDI and portfolio investment in terms of their relative stability. However, there are other studies which arrive at somewhat different conclusions than Claessens et.al. Empirical evidence for Latin American countries (ECLAC, 1995, Table IX.18) suggests that since 1980 FDI inflows have been less volatile than either long-term loans or short-term capital flows, short term being defined as less than one year. (It is

Cyclical behaviour and surges in FDI

Related to the above issue, there are two further significant matters that should be noted, namely, the question of FDI surges and the cyclical behaviour of FDI.

First, FDI surges pose equally acute macro-economic problems as do surges in portfolio investment. The recent experience of many developing countries has shown that surges in the latter often lead to over-valuation of the currency, causing current account disequilibrium which gives rise to the need for subsequent devaluation. These events in turn generate acute financial instability and also may lead to considerable fluctuations in real economic variables such as output and employment.

Second, although volatile, FDI may cause less macro-economic difficulties if it follows an anti-cyclical path. Pro-cyclical FDI flows may exacerbate economic fluctuations.[29] To the extent that profits retained by subsidiaries in host countries constitute a large part of FDI inflows into a country, these are likely to be pro-cyclical. (When general domestic economic conditions are good, profits are likely to be higher for both domestic firms and multinationals and more of the profit is likely to be reinvested locally by both groups of firms.) However, to the extent that economic cycles in the host countries do not coincide with those in the home countries, there may be a net FDI inflow which may be anti-cyclical rather than pro-cyclical. The net effect for the host country of the different phasing of economic cycles in the host and home country could be in either direction. Significantly, ECLAC (1995) reports some tentative evidence to suggest that net FDI flows for Latin America in the recent period have been pro-cyclical.

Financial fragility

To sum up, the impact of FDI depends on a number of factors such as the steadiness or volatility of FDI inflows, the proportion of FDI accounted for by profits retained by the subsidiary, the level of imports related to FDI and the percentage of output exported. It is quite possible for a situation to develop where foreign claims on currency reserves with respect to annual profits alone account for a high percentage of GDP, and where a decision to increase just the level of profit repatriation (with no liquidation of current assets) would need to be serviced by a high percentage of GDP. This would require a significant increase in export earnings, or in the export surplus, in order to avoid a foreign exchange crisis, an effort which in many if not most circumstances may be unsustainable. Similarly, a country accustomed to the ostensible permanence of FDI inflows, and using these to finance a

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interesting to note that the same source indicates that before 1980 long-term loans displayed less volatility than FDI). For the countries and time period studied by Calvo et.al. (1996) the evidence suggests that portfolio investment is more volatile than FDI.

[29] Pro-cyclical behaviour occurs when more investment takes place when the general level of economic activity in a country is high; when investment takes place when economic activity is low, it behaves in an anti-cyclical fashion.

continuing current account deficit, faces structural instability: any reduction or interruption of these flows may generate a foreign exchange crisis.[30]

The situation is well summed up as follows:

"Unless FDI flows are truly permanent -- in the sense that neither profits nor principal are repatriated -- the more successful a country is in attracting FDI and FDI is in terms of generating returns, the greater the risk of FDI flows producing fragility in a country's current account position and thus also in its exchange rate. Both of these factors will increase the currency risk of the FDI and lead to the increased probability of repatriation or hedging through the foreign exchange market If success also increases domestic incomes and costs -- thus reducing the rates of return offered to foreign investors -- this will not only reduce the size of FDI reinvestment flows and take pressure off the current account, but will also lead to a greater inducement to shift investments to other locations, and thus to a higher probability of shifts in invested capital." (Kregel, 1996.)

Multilateral financial institutions and other international organizations have not fully appreciated these hazards associated with FDI. The above analysis indicates clearly that developing country governments cannot be indifferent to either the sort of foreign direct investment offered or to the amount, because of both the latent and the structural instabilities associated with FDI which can have serious adverse consequences for the real economy.

In conventional analysis of the role of FDI the issue of the optimum flow or stock receives little attention. This is because at the micro-economic level FDI does not give rise to obligations -- dividends have to be paid only if profits are earned. Hence it is believed that that the more FDI, the better. However, a major implication of the previous paragraphs is that there is a level of FDI inflows and stocks which are optimal from the point of view of long term financial stability and therefore economic development, just as, by analogy, there is an optimum level of sustainable debt for a country. Hence, for most developing countries, a regime of unrestricted FDI (under an agreement such as the proposed OECD MAI) which may or may not correspond to the optimum level would by definition be inappropriate.

In order to inform debate and discussion and provide a firmer base for policy in these areas it would be of advantage for developing countries to press for more detailed empirical research work to be undertaken in for example UNCTAD on a number of key areas related to the above discussion and

[30] For a demonstration of the both the latent and the structural instabilities associated with FDI, and the associated fragility of the foreign account, on the basis of hypothetical, but not altogether unrealistic, scenarios, see Kregel, 1996.

taking into account the needs of countries at different stages of development and with different factor endowments. The following are some of the critical questions relating to the analytical arguments in the previous paragraphs which need further analysis:

a) Balance of payments

What are the factors or criteria which would provide an appropriate definition of a comfortable balance of payments position for any particular country, in the context of free capital movements? Is it enough to refer to a country's foreign exchange reserves or should a wider range of factors be taken into account and, if so, what should these be?

b) FDI, financial fragility and economic stability

Some of the central issues which need further analysis are the following:

- Is FDI pro-cyclical, counter-cyclical or neutral with respect to economic cycles?
- Are FDI flows more or less volatile than portfolio flows or other types of capital such as bank loans or long-term debt?
- How does FDI affect financial stability?
- Should surges in FDI be controlled and, if so, how?

2. FDI as a means of obtaining technology

It is common ground among analysts that technological development is a critical key to economic growth. A considerable body of research shows that the late industrializing countries (for example, Japan and subsequently South Korea), acquired access to technology from abroad instead of "re-inventing the wheel" in each case, thereby saving time and resources. In the context of this document, the key question from the point of view of a developing country is, therefore, whether FDI is the cheapest and most effective way of obtaining from abroad the technology it desires, as compared with the direct purchase of capital goods or licensing.

There are good *a priori* reasons for thinking that FDI may be an expensive if not the most expensive way for a developing country to obtain new technology. compared with, for example, purchasing capital goods using loans borrowed either by the company or the government.

This is due to the fact that FDI is a relatively expensive means of obtaining external financing. This is best appreciated if one approaches the matter from the point of view of the investing parent company, for whom risks are involved in all types of foreign investment, whether in the form of loans, portfolio investment, or FDI. The least risky form is loans, since they bear fixed known interest; portfolio investment is the next least risky because it can be liquidated relatively easily. FDI carries the greater risk. This is largely due to the intrinsic uncertainty regarding the future returns on FDI, as well as to FDI's relative illiquidity, which will partly depend on the level of development of local financial markets and of the economy itself. Even if there were adequate financial markets, as Kregel (1996) points out, the risks associated with FDI are less standardized and are therefore more costly to hedge and it is this which accounts for the higher risk attached to FDI and not its degree of permanence. For bearing these extra risks of FDI the foreign investor expects a higher rate of return. It is therefore not surprising that the "hurdle rate" for FDI is high. (See UNCTAD 1995a)

To the extent that FDI is a costly means of obtaining foreign exchange resources, it becomes an expensive means of acquiring technology. There are circumstances, of course, in which it is difficult to obtain technology in any other way except through FDI. For example, in some situations it is impossible to obtain loans as a source of foreign exchange in order to purchase capital goods or pay for licences.

Moreover, when proprietors have a monopoly over technological knowledge or a product, FDI will be the only means of obtaining the desired technology or product. In investing, the foreign company will attempt to obtain the maximum return in a situation in which it has strong bargaining power based on its exclusive ownership of know-how and patents. How much the company gains in "monopoly rents" (returns over and above what the firm would earn if it was not a monopoly but rather one competitor among others) depends on the bargaining power of the two sides. The bargaining strength of the developing country will depend, among other things, upon its own technological know-how and capacity to engage in reverse engineering, the industrial and technology policy of the government and its ability to enforce such a policy.[31] The bargaining between host government or potential partner and the intending foreign investor takes place over a number of factors such as the terms and conditions of investment, including local content, the transfer of R&D activities as part of the FDI, and the amount of technology transferred.

Taking into account the benefits and costs of FDI under present conditions and international rules affecting the matter, **it is suggested that it would be useful for a body such as UNCTAD to assess the existing literature and attempt to draw conclusions on whether FDI is the best way to acquire technology. It may also be useful to undertake further case studies regarding the differences between the first tier and second tier NICs with respect to the acquisition of technology and know-how and their reliance on multinationals. Furthermore, earlier proposals to establish a code for technology transfer should be reviewed to see whether these provide practical approaches to achieving increased transfers of technology through FDI.**

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[31] Reverse engineering is a method of evaluation of a product in order to understand its functional aspects and underlying ideas. This technique may be used to develop a similar or identical product.

3. The case for full global liberalization of FDI and the evidence

The exponents of FDI often argue that the benefits of a multilateral regime intended to liberalize FDI flows would not only accrue at a micro-economic and at a national level but would also be more general and systemic. It is believed that such a regime, together with freer trade (as a consequence of the Uruguay Round Agreements) would, in addition to generating more investment, lead to a better allocation of resources, greater economic efficiency and thereby faster economic growth at a global level. Some economists go further and suggest that a regime of free trade and capital movements (including FDI) will lead also to factor price equalization, that is, equality of real wages and profit rates world-wide.

However, the empirical evidence provides no support for believing that there are unqualified systemic gains from a regime of free trade and capital movements. If anything, the evidence suggests that there have been systemic losses. (South Centre, 1996.)

The world economy today is far more integrated in terms of trade and capital movements than it was in 1970. As seen above, there are far greater FDI flows now than at that time. Indeed, cross-border flows of financial capital, including FDI, have recorded a quantum leap since the abolition of exchange controls in leading industrial countries, a process which was virtually completed by the end of the 1970s. By 1995, more than US$ 1,260 billion flowed across the worlds' exchanges daily, an amount which greatly exceeded the daily combined value of world export and import merchandise trade which was US$ 27.2 billion in 1995. These financial flows were also higher than total daily world output (GDP), which in 1996 was US$ 82 billion. By 1997, the daily capital flows across the foreign exchanges are estimated to have almost doubled to $2,400 billion. Despite this enormous financial "progress", the performance of the real economy with respect to certain vital indicators in industrial countries, where the liberalization and integration process has gone furthest, is significantly worse now than it was in 1970, when these cross-border financial flows were quite small.

In 1970 there were 8 million people unemployed in the OECD countries and in 1995 35 million, that is, unemployment rose from about 3 per cent of the labour force to 10 per cent. Significantly, too, the trend rate of growth of production as well as productivity in the 1990s is half of what it was in the 1960s. The analysis of South Centre (1996) suggests that this deterioration in economic performance was due largely to the economic consequences of the regime of free financial flows itself. This regime, it is suggested, reduces the rate of growth of aggregate demand and output in a number of ways. (See also a recent UNDP study, Eatwell, 1996.)

Moreover, the evidence on convergence under liberalization is not encouraging. Before 1980, that is, before the process of liberalization and globalization reached the pace it has today, there was evidence of overall convergence in living standards between the North and the South, (the South's per capita growth rate of GDP in the period 1960-1980 was greater than that of the North) and there was a more pronounced convergence for several countries in all continents of the South.[32]

However, during the 1980s and the 1990s, the period during which the world economy has operated under a regime of freer trade and capital flows, there is no evidence of any general convergence between the living standards or real wages of citizens of the world's nation states. Liberalization and globalization, on the contrary, appear to be associated with greater divergence between the North and the South. There has also been divergence within the South, with a small number of newly industrialized countries – the (NICs) in Asia – having had a relatively much faster growth of per capita incomes than elsewhere in the South and in the North.

In view of the relevance to the theme of this document, it is important to assess to what extent this performance of Asian NICs is due to their supposedly liberal FDI regime. This issue is examined in the following sub-section.

Another and crucially important dimension of the systemic problems connected with a regime of fully liberalized FDI and other capital flows deserves particular note. Already workers and trades unions in the North are tending to blame imports from the South and FDI flows from North to South for their job losses and reduced growth in wages. So far, empirical evidence provides only limited support, if any, for this thesis.[33] Nevertheless, the increasing degree to which capital is "footloose" does reduce the bargaining power of the unions in the North and is therefore disadvantageous for labour in these countries. Arguably, it is also disadvantageous for society as a whole, since it makes it more difficult to organize co-operation between labour and capital in order to promote growth without inflation. (Glynn et. al., 1990; Eichengreen, 1996.) To the extent that liberalization is identified with serious threats to employment and living standards in the North, there is a strong possibility that liberalization policies will not be socially and politically sustainable.

With respect to the South, the previous sub-section outlined the ways in which unrestricted FDI movements may contribute to financial fragility in individual developing countries. However, in an interdependent world economy, as the case of Mexico illustrated in 1994, there may be serious systemic consequences through the so-called "contagion" effect. The latter leads to the transmission of financial fragility from the vulnerable to healthy economies via the workings of the financial markets. In addition to financial fragility, freely mobile FDI may also have other undesirable consequences. It could lead to

[32] The convention in measuring the per capita income of developing countries as a whole involves weighing the economic growth rates of individual countries by GDP per person. The question of convergence is a complex and controversial subject with a huge academic literature. For a careful and safe journey through this difficult terrain the reader is referred to UNCTAD, 1997, which *inter alia* provides detailed evidence and analysis on these issues.

[33] See, for example, Lawrence and Slaughter, 1993; Sachs and Shatz, 1994; UNCTAD,1995a; World Bank, 1995. For an opposite analysis and assessment of the empirical evidence see Wood, 1994.

short-termism, (that is, undue attention to short term profit), erosion of labour standards and conflicts between workers in the North and the South.[34]

F. East Asian economies and FDI

At this point it is instructive to examine the case of East Asian economies whose economic success has been attributed by some influential economists to their high degree of integration into the world economy and to their openness to FDI.

Degree of reliance on FDI

The first point to note in considering East Asian experience is that not all East Asian countries have been important recipients of FDI, but that flows to this region have been concentrated mainly in China, Hong Kong, Malaysia and Singapore. (See Table 3.) Notably, the outstandingly successful East Asian countries -- Japan and South Korea -- relied to an insignificant extent on FDI. Table 6 provides information on inward FDI flows in as a proportion of gross fixed capital formation for various regions and countries over the last decade.[35] It also shows that in South Korea, although the FDI inflows have been somewhat larger than those for Japan, these are still among the lowest for all developing countries, including even African countries. Relevant data for South Korea over a longer period (1970-1994) suggests a similar picture, that is, extremely small FDI inflows in comparison with other countries.[36]

It is significant that despite the low level of FDI flows, South Korea used such investment in a conscious strategic way to enhance its national technological development. An awareness of the costs as well as the benefits of FDI underpinned South Korea's industrial policy and attitude to FDI, as indicated in the South Korean Government's 1981 *White Paper on Foreign Investment* (EPB, 1981) referred to earlier.

[34] For a detailed analysis of this set of issues, see Singh, 1997b; Sengenberger and Wilkinson, 1995.
[35] Table 6 indicates that FDI inflows to Japan over the period 1984-1994 were less than one tenth of one per cent of gross domestic capital formation. The comparable figures for other developed countries are several orders of magnitude higher. FDI inflows to Japan have been minimal not only over the last decade but over the whole of the post-World War II period.
[36] For a discussion of FDI in South Korea over a longer period, see Chang, 1996.

Table 6

Inward FDI flows as a proportion of gross fixed capital formation

Various regions and selected countries, 1984-1994

	1984-1989 annual average %	**1991-1993 annual average %**	**1994 %**
All Countries	**3.1**	**3.8**	**3.9**
Developed Countries	**3.9**	**3.3**	**3.3**
European Union	4.7	5.6	**4.8**
France	3.5	7.7	7.1
Germany	1.0	1.4	-0.9
Netherlands	9.9	10.6	6.8
Sweden	3.4	9.5	23.1
UK	11.5	10.0	6.6
Switzerland	4.5	3.1	6.3
USA	5.8	3.2	4.8
Canada	5.4	4.3	5.9
Japan	-	0.1	0.1
Developing Countries	**2.8**	**5.7**	**7.5**
All developing countries minus China	***3.0***	***4.9***	***5.1***
Africa	**3.6**	**4.6**	**7.5**
Egypt	5.5	5.2	14.8
Ethiopia	0.1	1.2	1.0
Ghana	1.1	13.4	22.6
Nigeria	16.5	20.5	50.5
Senegal	0.9	1.0	1.1
Zambia	28.4	9.6	19.1
Zimbabwe	-0.9	1.2	2.7
Latin America & the Caribbean	**4.2**	**6.5**	**8.6**
Argentina	3.8	37.6	9.6
Brazil	2.3	1.5	3.0
Chile	15.6	8.5	19.9
Colombia	8.5	9.5	13.8
Jamaica	2.4	10.6	11.0
Mexico	7.8	6.8	10.4

Peru	0.1	2.4	30.3
Venezuela	0.7	9.3	6.7
Asia	**2.3**	**5.5**	**7.2**
Bangladesh	0.1	0.2	0.3
China	1.8	10.4	24.5
Hong Kong	12.2	5.7	8.2
India	0.2	0.4	1.1
Indonesia	1.6	4.5	3.6
South Korea	1.4	0.6	0.6
Malaysia	8.8	24.6	16.1
Philippines	5.1	4.6	9.6
Singapore	28.3	37.4	23.5
Thailand	4.4	4.7	1.1
Least Developed Countries	**1.1**	**4.1**	**0.9**

- *negligible*

Source*:* UNCTAD (1996a) *World Investment Report 1996* for 1984-89 and 1994, Annex table 5; UNCTAD (1995a) *World Investment Report 1995* for 1991-1993, Annex table 5.

A selective policy

Both South Korea and Taiwan imposed important restrictions on the entry of FDI and on the degree of ownership. In the case of South Korea, FDI was channelled into industries supplying critical intermediate inputs of complex technology, or labour intensive export industries generating foreign exchange and jobs, while it was prohibited in the consumer durables industry supplying the domestic market. (Chang, 1996.) Moreover, the governments in both these countries tried to encourage joint ventures, preferably under local majority ownership, in an attempt to facilitate technology transfer and the development of managerial skills.

Other resolute steps were taken by both governments to maximize technological spill-over from FDI including strict enforcement of local content requirements, clear preference for investors with the desired kind of technology and those willing to transfer technology to other domestic companies such as sub-contractors.

Although China, Malaysia and Singapore admitted much more FDI, they still operated a selective policy to a greater or lesser degree, in line with national priorities.[37] The only other major recipient of FDI in East Asia, namely Hong Kong, is the only one which has adopted a laissez-faire policy.[38]

Lessons from the East Asian experience

Two important developmental lessons follow from the East Asian experience with FDI. The first, which has already been emphasized earlier, concerns the need for selectivity and a strategic approach to FDI in the context of national policies to encourage socio-economic development and technological change.

The second is that there does not seem to be much correspondence between the liberality of a country's FDI regime and the inflows of FDI which it receives. It is notable that a conscious development-oriented framework for FDI does not necessarily inhibit FDI. China, for example, has a much more regulatory policy regime than India and yet it receives several times the amount of FDI than India. It may be argued that China is a unique case because of the enormous size of its potential market and can therefore afford to impose strict regulations. However, other much smaller South-East Asian countries, such as Malaysia and Thailand, also receive more FDI, despite their relatively more restrictive regimes, than several Latin American countries. Further, it should be noted that many African countries have among the most liberal regimes regarding FDI and yet many attract very little FDI, if any at all.

[37] For Malaysia, see further Rasiah, 1996; for China, see Mallampally, 1996 and Chang 1996, for Singapore see Lall, 1996.

[38] A critical analysis of Hong Kong's policies and the implications of these for this country's industrial development, see Lall, 1995; UNCTAD 1996b.)

The Asian experience underlines the conclusions from wider research which indicates that FDI depends largely on factors such as a country's per capita income and growth the availability of infrastructure and appropriate labour, rather than on a liberal trade and investment regime and investment incentives. Importantly, research suggests that the direction of causality is from economic growth to FDI rather than vice versa. (Kumar, 1996.) In an UNCTAD study on investment incentives and their effects on investors' decisions (UNCTAD, 1996c), evidence culled from analyses of investments in European countries by overseas firms suggests that the key factors in influencing their investment decisions have included the proximity of a large and growing market (the European single market), an adequate transport infrastructure to market the goods, high labour productivity, competitive wage rates, and attractive, well located industrial sites. It is also important to note that this study states that " ... there is overwhelming evidence to suggest that incentives are a relatively minor factor in the location decisions of TNCs relative to other locational advantages, such as market size and growth, production costs, skill levels, political and economic stability and the regulatory framework."

H. Brief policy conclusions

The main propositions with important policy implications, which have been highlighted by the analysis of this section, may be summarized as follows:

1. FDI can and does make an important contribution to development in a number of ways, provided certain conditions are met, with respect to:

   a) the nature of the projects which are undertaken;
   b) the timing of these projects; and
   c) setting prudent limits for the total amount of FDI.

2. The experience of successful countries in East Asia, where FDI has played a significant role, shows that these countries have by and large used such investment in a purposeful way, as part of the government's national and technological development policies. These countries have been selective in their use of FDI in the ways indicated above.

3. The current inclination of many developing countries to accept any and all FDI gives cause for concern in that such an approach may harbour trouble for their future development prospects. Not all FDI is conducive to development; some kinds may do more harm than good.

4. There are strong indications to suggest that FDI may not be the cheapest and most appropriate means of obtaining desired technology in all cases.

5. The present era of liberalization and globalization with its freer financial flows and increasingly sophisticated financial markets carries opportunities and also significant hazards for developing countries. This document has called particular attention to the latter as the international financial institutions emphasize only the former, and largely, if not altogether, overlook the latter. Specifically, it has been argued here that for developing countries, the current account balance still does matter and that, by inference, governments are obliged to intervene in order to correct the imbalances, using fiscal, monetary and other policies to restrict consumption and increase investment. The costs of government inaction in this area may be very high.[39] It is therefore important to assess the implications of FDI projects for a country's current and prospective balance of payments.

6. In relation to the above considerations, it was noted that there are inbuilt instabilities connected with FDI flows, in particular with respect to profits retained by subsidiaries. Under certain circumstances these can generate financial crises.

7. The volatile nature of FDI flows and their possible pro-cyclical nature also give cause for concern.

These characteristics of FDI suggest the following broad policy conclusions:

1. The best way, therefore, to limit the risks associated with FDI, avoid its undesirable effects, and increase the likelihood of it making a positive contribution to a country's socio-economic development efforts is to pursue a policy of:

- selectivity with respect to the magnitude and timing of capital inflows including FDI. This implies that governments should be able to determine the composition of capital inflows and to formulate appropriate policies of government intervention to manage capital inflows, including those of FDI;

- selectivity with respect to specific projects, with preference for those with large technological spill-overs or other important socio-economic benefits. This may involve confining FDI to economic sectors and sub-sectors regarded as priorities in the country's overall socio-economic development.[40]

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[39] In technical economic terms financial markets suffer from inherent imperfections, including, specifically, informational asymmetries as well as incomplete markets together with the difficulties of writing complete contracts. This makes such markets particularly prone to coordination failures, the prevention of which requires government action. See further Stiglitz, 1994.

[40] Some may argue that it may be well and good if investment goes to priority sectors but that no harm will be done if it also goes into non-priority sectors. As the discussion in the above section has indicated, taking into account all the relevant costs and benefits and macro-implications of the kind adumbrated, there may well be FDI projects where the costs to the economy and society exceed the

- prudence with respect to total FDI flows as well as FDI stock so as not to render the economy financially more fragile in the context of future economic shocks.[41]

2. A global investment regime which took away a developing country's ability to select among FDI projects and to regulate inflows for macro-economic reasons would hinder development and prejudice economic stability. Indeed, the now advanced industrial countries built up to their present economic strength under a regime of strict controls over inflows and outflows of capital, relaxing them only gradually and, in some cases, only relatively recently.[42] Such an erosion of government autonomy in decision-making with respect to FDI as implied by current North proposals can have serious economic and political consequences.

3. With regard to investment incentives, the evidence is that investment incentives make only a marginal difference to the likelihood of attracting FDI. However, at present no country can afford to refrain from offering such incentives from fear that potential investment will flow to similarly placed countries with respect to locational advantages but which also offer investment incentives. Clearly, all developing countries lose from competition among themselves to offer ever greater foreign investment incentives. The policy conclusion to be drawn, therefore, is that, in addition to being selective in their acceptance of FDI, developing countries would benefit collectively from co-operation on the matter of investment incentives rather than competition in this sphere.[43]

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benefits. Clearly such projects should be screened out, or certainly discouraged by developing country policies which are mindful of the aggregate effects of FDI

[41] Such economic shocks (for example, a major change in the terms of trade as a result of external events or a significant shift in international interest rates), are likely to affect both domestic and foreign investors, when there is financial fragility. Not only are foreign investors prone to withdraw their capital, but domestic investors may also engage in capital flight. Whereas in principle the government can take measures such as introducing exchange controls to discipline domestic investors, they would not be able to control adequately the activities of foreign investors, were an OECD-type multilateral investment agreement in place.

[42] In this context, it should be recalled that the now advanced industrial countries maintained direct controls over capital inflows until quite a late stage in their development. Moreover, capital account convertibility has only been introduced relatively recently in the advanced industrial countries -- in the 197Os in for example the Canada, Germany, the United States and the UK and in 1980 in Japan. It was only in 1990 that France and Italy introduced full capital account convertibility. (South Centre, 1996.)

[43] They will in any case need to consider a joint approach to the matter of investment incentives that forms part of the agenda relating to the WTO Agreement on Subsidies and Countervailing Measures (ASCM.) Already ASCM stipulates that certain fiscal, financial or indirect incentives are considered as subsidies in that they provide a financial contribution or constitute an incoming payment foregone by a government or public body. As such they are prohibited and subject to multilateral disciplines.

Part III. The Need for a Collective Stand by Developing Countries on FDI Matters

A. The nature of the challenge in the international arena

The evidence and analysis of Part II suggest that FDI can be a powerful force for economic development, provided that countries using it are prudent and selective. The current untidy FDI regime, comprising a melée of bilateral and regional agreements, at least has the virtue of allowing developing countries some discretion in their policies towards FDI.[44] The challenge facing developing country governments today is that, whether in the name of rationalizing the current arrangements or introducing greater liberalization, the prospective changes in the international FDI regime will dilute their current discretionary powers to formulate an appropriate policy framework.

As mentioned earlier the OECD governments wish to set global rules of the game which establish a highly liberalized regime for FDI. The stand taken by developing countries at the Singapore WTO Ministerial Conference was to "wait and see" the results of the WTO and UNCTAD studies in order to decide whether or not there was a case for multilateral negotiations on FDI matters. However developing countries members of the WTO are already obliged to negotiate on key FDI matters in relation to the Uruguay Round built-in agenda on Trade-Related Investment Measures (TRIMs) among others.

Arguably the most important matter which requires the immediate attention of the developing countries is the impending OECD MAI, which the member countries are negotiating among themselves. The proposed agreement is highly complex with far-reaching global political and economic implications. In view of its potential significance for all countries, non-OECD as well as OECD, it is important to take note of progress in the negotiations. Events could move in a direction such that developing countries may be forced to take a position on the MAI, sooner rather than later.

It is clear that, from the perspective of developing countries, the MAI has several serious drawbacks. For example, developing countries would not have the right to choose the composition of their total capital inflows, to select between FDI projects or to decide on the phasing of foreign investment in their economies. They would also be precluded from setting performance requirements

[44] For a compendium of bilateral investment instruments, see UNCTAD, 1996e. UNCTAD (forthcoming) will provide an analysis of the existing bilateral agreements, and the policy conclusions to be drawn.

for foreign investors with a view to ensuring they contribute to the country's socio-economic development objectives.[45]

Yet, the OECD's Agreement will in effect constitute a major step towards establishing a global rule of law in this field, bearing in mind that it is to be established among the countries accounting for the bulk of outflows and inflows of FDI, that it rationalizes and improves upon existing agreements with a view to "raising the standards" applying to FDI, and that it will be backed up by dispute settlement procedures. If several major developing countries were to join the MAI, the latter will be tantamount to a global regime, which other developing countries will hardly be able to ignore. Furthermore, it is important to appreciate that the admittance of developing countries to the MAI will be negotiated on an individual basis, with no power to affect the basic content and little leverage, if any, to have significant national reservations accepted.

Efforts are being made to encourage non-OECD members to consider eventually joining the MAI, particularly those countries with considerable FDI inflows and those beginning to be sources of FDI. Regular contacts are made with Paris embassies, and regional seminars have been organized to promote the MAI in Asia and Latin America. Some Latin American countries, in particular Chile and Mexico, could well decide to participate since this would be quite consistent with their current FDI policies. Also some Asian countries with high levels of FDI may also be under pressure to join, the more so if their current fragile economic situation would be further prejudiced, should the financial markets interpret a "refusal" to join as a bad omen. Other developing countries may feel pressured into discussing joining from fear that they will otherwise be excluded as potential host countries to FDI.

The risk is that a decision by more advanced developing countries who are already heavily dependent on FDI to join as original contracting parties could well lead to an irresistible momentum for others to join. Once a number of developing countries had joined the ranks of the signatories, there could well be a decision to take the agreement to the WTO for negotiation, not least in order to reinforce the retaliation for infringements with cross-sanctions.

Were the OECD model of an investment agreement to be introduced into the WTO, it would be difficult for developing countries who were not members of the OECD MAI to make significant development-oriented changes to what had become a widely accepted agreement. In the light of the history of negotiations, for example during the Uruguay Round, this scenario is by no means unrealistic.

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[45] The OECD Multilateral Agreement on Investment (MAI) has been described as a freedom charter for the multinationals. (Monbiot, 1997.) Indeed, it represents almost the antithesis of the two draft non-binding multilateral codes of conduct which the South had previously tried to promote -- the 1983 Draft United Nations Code of Conduct on Transnational Corporations, and the 1985 Draft International Code of Conduct on the Transfer of Technology. Neither of these were adopted, as a result of strong opposition from the developed countries. (For the texts of these documents see UNCTAD, 1996d.)

B. The options available to the South

In this complex and changing background, where the countries of the North have so far held the initiative, developing countries are faced with a difficult task of deciding what is the best course of action to take.

1. "Wait and see"

The most tempting position to adopt -- that of "wait and see" -- is the one which developing country Ministers opted for at the Singapore meeting. Nevertheless, such a strategy can take two forms: to wait *passively* as a group for the results of the WTO and UNCTAD studies or to use this interim period in a more *active* way as a group in order to develop a clear perception of the interests they wish to promote or defend collectively in relation to FDI.

There are few arguments in favour of a wholly passive "wait and see" position. One possible advantage of the passive wait and see strategy is that it is a useful delaying tactic and of course it is easier to follow in view of the difficulties of mounting a group stand. It may also be claimed that the present regime comprising bilateral and regional rules is the best from the point of view of developing countries. So why change anything?

However, it may be impossible to hold this position for long as there are powerful forces pressuring for change, which may also push bilateral agreements in a more liberal direction, to reflect the "high standards" of the OECD MAI. Furthermore, if this stance is adopted, developing countries will be wholly unprepared for the discussion and negotiation on the UR in-built agenda items, as also for the discussions relating to the studies on investment matters in UNCTAD and the WTO. Nor will they be prepared to react to the overtures from the OECD regarding MAI. The "wait and see" period will therefore have served little or no constructive purpose.

2. Preparing the ground

The situation described above would suggest that developing countries adopt a more active stance to at least :

- keep a close watch on the developing situation with regard to the OECD MAI;
- contribute to the careful definition of the specific issues to be studied in WTO and UNCTAD on FDI related matters;
- prepare positions on the investment-related matters on the Uruguay Round in-built agenda; and
- consult among themselves and coordinate their views on these various FDI matters.

3. An active South agenda

There would be several advantages to the South in adopting an even more active stance than that represented by engaging in the "preparatory" activities listed above. This would involve formulating a South agenda on FDI matters, comprising a South view of FDI issues to be pursued in the scheduled activities in various international fora, *****and if necessary proposing additional items***. Such an agenda, outlined in more detail further below, would have the following benefits:

- This South agenda would allow for a coherent integrated approach to be adopted with respect to any proposed wider multilateral agreement and also to the in-built WTO agenda items on investment matters, which in a disjointed way constitute universal ground rules affecting FDI.

- It would also prepare the developing countries for effective participation in the discussions to be held in relation to the studies conducted in UNCTAD and the WTO on investment and related matters.

- Instead of continuing to merely react to the North's demands as in the past ten years or so, this strategy would convey a clear statement of intent from the South to the North that the South had clearly defined interests and objectives regarding the global rules of the game with respect to FDI, as well as trade and other matters. This may allow the South to achieve more than it has in the past, in part by possibly facilitating alliances with parts of the North.

- Moreover, a joint approach by developing countries will more effectively counter that of the North which will, as a matter of course, have a joint position, by virtue of the adoption of a joint stance by the European Union members and by the OECD countries in relation to their own MAI.

- If put forward early enough, the agenda might give rise to some give and take on the part of the developed countries and could pre-empt a *fait accompli* in the form of the OECD MAI.

- Providing another viable option on global FDI matters for those developing countries seriously contemplating joining the MAI, *****the agenda*** could help to improve the cohesion among South countries.

- An active South agenda would lend itself to discussing and negotiating a wider set of issues of key concern to the South.

D. Elements for an active South agenda

1. A development-sensitive policy framework for FDI

A basic and crucial element of an active South agenda would be the definition of a set of principles for a policy framework for FDI, corresponding to developing countries' interests in this matter and representing a shared view among them.

The highly liberal global investment regime to be established by the OECD mainly focuses on establishing rights and guarantees for investors. From the South's perspective, however, what is needed is a set of ground rules which, while guaranteeing adequate basic protection for foreign investment, also serves more fully the South's development requirements.[46] Such a policy framework would, at the least, need to include elements which:

- allowed countries to be *selective with regard to the timing of FDI and to actual FDI projects*, according to their current development level and needs;

- legitimized *"qualified" market access* so that a potential host country could specify the degree to which it would give national access, in terms of the percentage limit on foreign shareholding, or the total value of individual or aggregate foreign investment;

- prevented the abuse of monopoly power by large multinationals, encouraging, as far as possible, level playing fields between large foreign investors and smaller domestic companies so that the latter can continue to operate and flourish;

- permitted *limitations to national treatment,* giving governments scope to stipulate performance requirements and similar measures, TRIMs not withstanding, in order to encourage foreign enterprises to contribute to development objectives, including a healthy balance of payments*;*

- established *rules of conduct for foreign investors* to prevent bribery and corruption and tax avoidance through transfer pricing, among other things.

Furthermore, if, in the light of events, it is concluded that there has to be a multilateral regime for FDI, an approach worth considering is that based on a "positive" list approach to liberalization, whereby

[46] The ground rules to provide a credible and predictable environment for overseas investment, whether by investors from the North or the South, would need to guarantee the protection of investment and provide an appropriate dispute settlement mechanism, suitably designed to take account of developing countries' circumstances.

each country specifies the economic sectors and industries, if any, in which it is willing to open up to foreign investors and in which it is willing to assume the treaty obligations. A South strategy on these lines would thus give each developing country the scope to determine its own pace and approach to the liberalization of FDI. An agreement based on this approach offers a realistic alternative to those developing countries tempted to join the OECD MAI and it could thereby pre-empt a potentially damaging division within the South.[47]

2. Formulating competition policy and the issue of "level playing fields".

A very important issue raised by the increasing liberalization of world trade and capital movements is that concerning the kind of competition policy which, at both the national and international levels, will be conducive to economic development or at least not hinder it. This question becomes all the more acute in the context of proposed global investment agreements, such as the OECD MAI, which remove most of the restraints on the activities of multinationals. Two crucial sets of matters need to be addressed, first, the prevention of the abuse of monopoly power, predation etc., by large multinationals and second, that of "level playing fields", so that the existence of national firms is not endangered or their development hindered. This requires developing countries as a group to begin evolving a view as to the sort of national and international competition policy that would best serve their development interests. It also requires the international community to give attention to the important issues in the area, as outlined below.

Taking the question of level playing fields first, the use, or misuse, of the concept "level playing fields" frequently creates confusion. Common sense would suggest that, in order for there to be a level playing field for actors or participants of very different competitive ability in terms of economic capacity and power, there is a need to introduce measures to help the less equipped and/or hold back the relatively better prepared. Nevertheless, in the North's efforts to change the global rules of the game through liberalization, the clear objective is to establish policies and rules which are applicable to all countries irrespective of their level of development, the only concession to developing countries being a somewhat longer time span to implement the new multilaterally agreed policies.

Even the largest developing country firms are, on the whole, much smaller than the typical large foreign investors from the North. The foreign firm not only will have access to foreign capital on cheaper terms but, because of its size, it may also have easier and cheaper access than local firms to

[47] Such an approach is not wholly idealistic. The General Agreement on Trade in Services (GATS), which has been negotiated as part of the Uruguay Round, provides an important partial precedent, in that it allows countries to choose the areas and the degree to which they wish to open up to foreign investment and permits an evolution of their position over time in accordance with national policy objectives. However, in contrast with the GATS agreement, where there is a sector by sector rolling programme, the proposal here envisages that countries could offer, or not as the case may be, liberalization in any sectors whatsoever and not in predetermined broad sectors.

host country capital markets. An appropriate competition policy framework will be required to address this issue of unfair competition which has a very significant development dimension.

Turning to the traditional competition policy question of regulating market power and the conduct of dominant firms, the first important point is that most developing countries do not have adequate competition laws to regulate market power and the conduct of dominant firms. It may be thought that this problem is easily remedied by providing technical assistance to help formulate competition laws in developing countries. Indeed such assistance is currently being provided to a number of countries by UNCTAD. However, the difficulties lie deeper, in that many of these countries do not have the requisite administrative capacity or the political will or economic leverage needed to implement their competition laws. Moreover, there is evidence to suggest that the technical assistance provided often transmits patterns of competition policy from Northern economies which is not appropriate to their needs and level of development.

In this context, it should be appreciated that even among advanced countries there is no agreement on or harmonization of domestic competition policies. This is in part because different countries not only have different laws but also fundamentally different philosophies on the question of competition and varying interpretations of its impact on their economies.

The United States, for example, which has a long history and considerable body of competition law regards competition to be an objective in itself, rather than constituting a means to an end, (for example, economic welfare or faster growth). On the other hand, Japan and several European countries have normally regarded competition policy to be an integral part of their countries' industrial policy, and assessed its success according to whether or not it leads to greater efficiency or, in a dynamic sense, more productivity growth. In simple terms, in the implementation of their competition laws the Japanese have tried to avoid allowing too little or too much competition. Too little competition is deemed to lead to the usual problems of lack of incentive for economic progress; on the other hand, too much competition may be ruinous in that it whittles away producers' profits and thereby reduces their willingness and ability to invest, thus reducing future productivity growth. Hence what the Japanese have attempted to do is to institute a regime of what they regard as optimal competition to complement their industrial policy, which is also geared towards promoting greater investment and greater long term growth of productivity.

From the perspective of developing countries, a Japanese type of competition policy which promotes both co-operation and competition between firms is more suitable for meeting their development goals. In view of these countries' underdevelopment and the lack of competitive capabilities of most domestic firms in developing countries, domestic competition authorities may, for example, promote mergers among domestic companies, whilst prohibiting take-overs of domestic firms by larger foreign enterprises. This implies the need for discretion on the part of the competition authorities in the implementation of domestic competition policies. Agreement on domestic competition policies (as part of a broader multilateral investment agreement), which enshrined the concept of national treatment, would clearly be inappropriate for developing countries, in view of the "infant" status of most of their firms relative to most multinationals.

Thus, agreement and action are required both on the competition policies which developing countries themselves should implement and also on international competition policy to deal with issues which domestic competition policies cannot tackle.

The difficulties of achieving agreement on domestic competition policies between the advanced countries, let alone between those of the South and of the North, are severe. But additional difficulties are faced in the context of a more liberal investment regime. These relate to the question of abuse of monopoly power by dominant firms in a variety of ways which cannot be controlled by national competition authorities, because many multinational firms operate on an international scale. Without an international competition law and authority or close international co-operation by domestic competition authorities, it is difficult to ensure that international mergers and strategic alliances between large multinational firms do not have unhealthy anti-competitive effects and do not thereby seriously undermine the "contestability" of markets.

From the point of view of developing countries, it is extremely important to ensure that these large multinational firms do not simply set up market sharing arrangements with respect to third world countries at the expense of their consumers and producers, instead of competing with one another. Similarly, the abuse of market power in the form of predation (whereby a large firm deliberately sets low prices for a short period of time in order to drive out rivals), may be difficult for developing country competition authorities to deal with, as they may not have access to the necessary information to prove "predation" by large multinationals.

There need to be rules which permit developing countries to pursue domestic competition policies conducive to development and which incorporate or are accompanied by an appropriate international competition policy to ensure that large multinationals actually do compete and do not simply split the world into territorial monopolies.

Recently, the European Trade Commissioner called on the WTO to examine co-operation on competition issues, stressing the "need for an international agreement on competition rules and smoother co-operation between national competition jurisdictions". Failing this, he foresaw an increasing number of "clashes when powerful competition authorities sought to deal with the same case applying different rules". He proposed that the WTO explore "all the implications of competition policy for the world trading system, so that WTO members can take a fully considered decision on how best to deal with these implications in the next major round of WTO talks."

The earlier paragraphs in which competition policy was discussed from a development perspective, rather than from the trade angle, concluded that for developing countries it was of considerable importance what type of national and international competition policy was put in place. Irrespective of the clear differences of attitude between the European Union and the United States on international competition, it is clear that these major economic powers are unlikely to promote ideas on international competition policy intended to improve development prospects in the South.

In defence of their own interests, developing countries as a group therefore need to act as a protagonist from an early date, putting forward their own proposals on the principles of an international competition policy which would assist their development.

3. Requesting further research on FDI-related matters

In order to inform debate and discussion and provide a firmer base for policy, the developing countries should press for more detailed work to be undertaken in UNCTAD -- in possible collaboration with the UN Regional Economic Commissions -- on a number of key FDI-related areas. The following are some of the issues for further research, some of which have already been mentioned earlier in this document:

Balance of payments

What are the factors or criteria which would provide an appropriate definition of a comfortable balance of payments position for any particular country, in the context of free capital movements? Is it enough to refer to a country's foreign exchange reserves or should a wider range of factors be taken into account and, if so, what should these be?

FDI and financial and economic stability

Some of the central issues which need further analysis are the following:

- Is FDI pro-cyclical, counter-cyclical or neutral with respect to economic cycles?

- Are FDI flows more or less volatile than portfolio flows or other types of capital such as bank loans or long-term debt?

- How does FDI affect financial stability?

- Should surges in FDI be controlled and, if so, how?

FDI and the transfer of technology

Taking into account the benefits and costs of FDI under present conditions and international rules affecting FDI, is FDI the best way to acquire technology,? It would be useful to assess the existing literature on the matter and attempt to draw conclusions. It may also be useful to undertake further case studies regarding the differences between the first tier and second tier NICs with respect to the acquisition of technology and know-how and their reliance on multinationals. Earlier proposals to establish a code for technology transfer should be reviewed to see whether these provide practical approaches to achieving increased transfers of technology through FDI.

The determinants and characteristics of FDI flows

Key questions in this field which require more light to be shed on them are:

- What factors explain why ten or so developing countries receive most of the FDI inflows to developing countries, even though they have very different degrees of openness to FDI?
- What steps can be taken to ensure a wider distribution of beneficial FDI among developing countries?
- Are the determinants of developing countries' outward FDI different from those of developed country FDI?
- Are the least developed countries more likely to attract developing country FDI than developed country FDI? Is this more beneficial for least developed countries and if so what can the international community do to ensure an increase in such flows?
- In what respect, if at all, is US FDI in Latin America different from Japanese FDI in Asia? Is the latter more beneficial and, if so, why?

A South-South code for FDI

A South-South code for investment among developing countries was proposed in the report of the South Commission *The Challenge to the South*. The feasibility and possible content of such a code should be studied in depth.

4. Initiating collective action

In order to work towards evolving an active South agenda, the following practical steps suggest themselves:

- The Group of 77 in Geneva should establish a small working group on FDI matters, which would meet regularly to review the related issues and proceedings, report to the G77 and recommend a course of action to be taken.

- FDI-related country studies should be undertaken in different parts of the South in order to compare experiences and responses in practical situations and to draw conclusions that bear on the issues involved in considering global FDU arrangements. The South experts and institutions involved in these FDI studies should be linked electronically via Internet in order to further their work.

- An expert group should be set up to monitor OECD MAI-related proceedings, to study in depth the OECD draft agreement and its implications for the South, and to report its conclusions to the Group of 77.

Part IV. By Way of a Conclusion

This document has examined a number of key aspects of the role of FDI in economic development and the nature of the challenge which a North-driven and North-defined global regime on FDI presents for the countries of the South. The analysis suggests that action is required on the part of the South, at least in preparation for FDI-related matters already firmly lodged on the international agenda, if not also to develop its own agenda and to promote it actively in the international arena.

Indeed, the recent experiences of the developing countries have only served to illustrate once again the need for them to be fully prepared and informed when engaging in negotiations with the North. As importantly, they need to coordinate their action and act together, if they wish to exercise influence and carry weight in negotiations in order to arrive at balanced and satisfactory arrangements.

In order to highlight the key analytical points and policy conclusions of this document, a summary of these is presented at the beginning of this document.

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Appendix

Organisation for Economic Co-operation and Development[48]

A Multilateral Agreement on Investment

Report by the Committee on International Investment and Multinational Enterprises (CIME) and the Committee on Capital Movement and Invisible Transactions (CMIT)

Introduction

The time is ripe to negotiate a multilateral agreement on investment (MAI) in the OECD. The Committee on International Investment and Multinational Enterprises (CIME) and the Committee on Capital Movement and Invisible Transactions (CMIT) are convinced that the foundations have now been laid for the successful negotiation of such an agreement building on OECD's existing instruments and expertise. (The technical analysis is summarised in the Annexe.)

This agreement is needed to respond to the dramatic growth and transformation of foreign direct investment (FDI) which has been spurred by widespread liberalisation and increasing competition for investment capital. Foreign investors still encounter investment barriers, discriminatory treatment and uncertainties. OECD governments and the European Communities, the business community and labour are urging new multilateral rules which set high standards and a balanced and equitable framework for dealing with investment issues.

A multilateral agreement on investment would provide a strong and comprehensive framework for international investment and would strengthen the multilateral trading regime. It would set clear, consistent and transparent rules on liberalisation and investor protection, with dispute settlement, thereby underpinning the continued removal of barriers to market access and encouraging economic growth. It would be open to all OECD Members and the European Communities and to accession by non-OECD Member countries. The MAI would provide a benchmark against which potential investors would assess the openness and legal security offered by countries as investment locations. This would, in turn, act as a spur to further liberalisation.

Pursuant to the mandate of the June 1994 OECD Ministerial, the Committees therefore request that the meeting of the OECD Council at Ministerial level now adopt the mandate for negotiating a multilateral agreement on investment as set out in Section III. below. Although a major effort will be required by all parties to resolve outstanding issues under the new mandate, the objective would be to conclude the agreement by the time of the Ministerial meeting in 1997.

[48] OECD/GD(95)65, 1995.

1. The case for a Multilateral Agreement on Investment in the OECD

Foreign direct investment (FDI) flows have grown spectacularly over the past years and have brought benefits not only to OECD countries long-accustomed to serving as FDI hosts and exporters, but also to a growing number of non-OECD countries especially those of the Dynamic Asian Economies, Latin America, and central and eastern Europe. Investment, both inward and outward, impacts positively on economic growth, productivity and competitiveness. Increasing competition for limited investment capital is drawing attention to the need for investment rules which preserves the benefits of FDI while providing a more level playing field.

Growth in FDI has been underpinned by widespread liberalisation which has swept away many formal governmental restrictions on investment and severely curtailed others. Remaining restrictions are a source of friction not least because they are widely perceived as barriers to market access. A tendency to resort to unilateral measures, including reciprocity, as a way of forcing more market access threatens to undermine the principle of non-discrimination on which OECD liberalisation has been traditionally based.

The OECD Codes of Liberalisation and the other investment instruments continue to be a positive force for liberalisation among OECD countries. However there is no comprehensive multilateral agreement on international investment.

Non-members are entering the investment scene as both recipient and source countries. Controversies which in the past impeded FDI flows to these countries have given way to a more positive views towards open FDI regimes. It is unclear whether and how many non-Member countries would join an MAI but indications are that many of them are eager to discuss investment rules if the game which would confer mutual advantages to OECD and non-OECD countries. The Committees attach great importance to further developing dialogue with these countries as MAI negotiations proceed.

A carefully constructed investment agreement would not only ensure that there is no conflict between the investment and trading regimes but that these complement one another until such time as they might perhaps be successfully integrated. A state-of-the-art agreement negotiated in OECD would be an important step on the road to a truly universal investment regime.

The business community and labour, represented by BIAC and TUAC, strongly support a MAI which sets high standards and a balanced and equitable framework for dealing with investment issues.

2. Features of a Multilateral Agreement on Investment

The MAI would build on the achievements of the present OECD instruments, consolidating and strengthening existing commitments under the Codes of Liberalisation and the 1976 Declaration and Decisions on International Investment and Multinational Enterprises. The aim of negotiations is to conclude an agreement incorporating rollback, standstill, national treatment and non-discrimination/most favoured nations (MFN) as well as new disciplines to improve market access and to strengthen the basis of mutual confidence between enterprises and states. The liberalisation obligations would be complemented by provisions on investment protection. The obligations under the agreement would need to be reinforced by effective dispute settlement procedures.

The agreement would be comprehensive in scope, covering all sectors under a broad definition on investment focusing mainly of FDI. The MAI would aim to raise the level of existing liberalisation based on a "top-down" approach under which the only exceptions permitted are those listed when adhering to the agreement and which are subject to progressive liberalisation. The multilateral character of the agreement would be reinforced by embodying the principles of national treatment and non-discrimination/MFN and by opening it to accession by non-Member countries.

In particular, the aim of the negotiations is to achieve an agreement, with a satisfactory scope and balance of commitments, that would:

a) set high standards for the treatment and protection of investment;
b) go beyond existing commitments to achieve a high standard of liberalisation covering both the establishment and post-establishment phase with broad obligations on national treatment, standstill, roll-back, non-discrimination/MFN, and transparency, and apply disciplines to areas of liberalisation not satisfactorily covered by the present OECD instrument;
c) be legally binding and contain provisions regarding its enforcement;
d) apply these commitments to all parties to the MAI at all levels of government;
e) deal with measures taken in the context of regional economic integration organisations;
f) encourage conciliation and provide for effective resolution of disputes, taking account of existing mechanisms;
g) take account of Member countries' international commitments with a view to avoiding conflicts with agreements in the WTO such as GATS, TRIMS, and TRIPS; and with tax agreements; and similarly seek to avoid conflicts with internationally accepted principles of taxation.

The agreement would make an important contribution to strengthening the multilateral system by providing better protection, further liberalisation and a basis for co-operation with non-Members. Contacts will be maintained between OECD and other international organisations, including WTO and ICSID.

To ensure that areas of common interest are adequately addressed, there will be a need for close co-operation with the Trade Committee. Similarly, taxation aspects in the MAI will be examined with the Committee on Fiscal Affairs.

3. Mandate

Accordingly, the Committee request a mandate from the Council at Ministerial level for the negotiation of a multilateral agreement on investment which would:

- provide a broad multilateral/framework for international investment with high standards for the liberalisation of investment regimes and investment protection and with effective dispute settlement procedures;

- be a free-standing international treaty open to all OECD Members and the European Communities, and to accession by non-OECD Member countries.

Close co-operation will be ensured with the appropriate OECD Committees, including the trade Committee and the Committee on Fiscal Affairs to take account of areas of common interest.

Negotiations should commence immediately with the objective of reaching an agreement by the time of the Ministerial meeting in 1997, with a progress report to the Ministerial meeting in 1996.

Given the desirability of including non-Member countries in an MAI, arrangements will be made for consulting them as negotiations progress.

Organisation for Economic Co-operation and Development,
Document OECD/GD(95)65, Paris 1995.

Annex

Since 1991, work on a multilateral agreement on investment has been conducted by the Committee on International Investment and Multinational Enterprises (CIME) and by the Committee on Capital Movements and Invisible Transactions (CMIT). The technical and analytical work was undertaken by five working groups, composed of independent governmental experts, set up in 1994 to explore the major issues of this agreement.

The groups dealt respectively with liberalisation obligations under existing OECD instruments, liberalisation obligations in new areas, investment protection, dispute settlement, and the involvement of non-Members and institutional matters. This phase of intensive analysis included discussions of possible solutions, many of which were inspired by recently negotiated agreements such as the NAFTA, the Energy Charter Treaty, or bilateral investment treaties (BITs).

The following section is a summary of the main results of the working groups. It reflects the issues and options as identified by the groups during the preparatory phase for negotiations. This summary does not prejudge how the issues will be resolved in the context of the forthcoming negotiations.

Liberalisation

The MAI would aim to set high standards of liberalisation. Options have been identified which go well beyond the provisions of OECD instruments or even provisions in other international agreements where higher standards already apply. This would result in strong obligations and commitments on national treatment, non-discrimination/MFN, transparency, standstill, roll-back and in the various procedures to implement these principles. This "top-down" approach means that the only exceptions to the obligations permitted are those listed when adhering to the agreement and which are subject to progressive liberalisation. Peer pressure to promote roll-back of remaining restrictions is another feature of the existing instruments that could be retained.

Difficult issues will no doubt concern qualifications to the basic obligations e.g., possible exceptions to non-discrimination including reciprocity measures and the issue of MFN and free-riders; the degree of liberalisation to be achieved as from the time the agreement takes effect; and the scope of a national security provision.

It is important to find a solution to the issues of subnational measures. Several options were identified based on solutions which were adopted by certain federal countries in other international agreements. The agreement would also need to deal with measures taken in the context of regional economic integration organisations taking account of the economic rationale for these measures. The goal in each case is to provide for stronger obligations than in the current OECD instruments and to apply those obligations equally to all parties to the MAI.

Further analysis of new liberalisation issues will need to be done including, the movement and employment of key personnel, mandatory performance requirements, privatisation, state enterprises, monopolies, concessions, corporate practices and investment incentives. The analysis so far suggests that as regards mandatory performance requirements there would be scope for the MAI to go further than the TRIMS agreement in addressing investment-distorting measures. While disciplines on key personnel, both their movement into a country and the right to employ personnel without regard to nationality, may be covered in a MAI, the need to respect host country's immigration policy prerogatives is fully recognised. Rules providing for national treatment and non-discriminatory treatment of foreign investors in the case of privatisation will be examined. It might also be feasible to consider imposing disciplines on the behaviour of state enterprises and monopolies which would ensure national treatment and non-discrimination/MFN for foreign investors.

Investment Protection

Provisions on expropriation, compensation and the transfer of funds are key elements of investment protection. These provisions are particularly relevant in an agreement which is open to non-Member countries. A comprehensive investment instrument would contain strong obligations in these areas and would also address issues such as subrogation, observance of other obligations, and protection from strife. The goal is to provide levels of investment promotion and protection which are at least as strong as those negotiated by Member countries in other investment treaties.

The MAI would guarantee the investor and the investment fair and equitable treatment and full protection and security. Such a general treatment provision is usually supplemented by national treatment and non-discrimination obligations which would apply to all matters of investment protection. Guidance may be found in the solutions adopted in bilateral and multilateral instruments.

The exact scope of the investment protection provisions will be determined by the outcome of the negotiations, particularly the definition of investment to which the protection provisions will apply and the dispute settlement mechanisms available to enforce them. There are different practices among Member countries with regard to such issues as the definition of expropriation and the conditions relating thereto (including due process), the method for calculating compensation (as well as the possibility of judicial review), the applicable exchange rate, and the right of transfer.

Dispute Settlement

The agreement would contain conciliation and dispute settlement mechanisms. The precise mechanisms would be a function of the definition of investment and the nature of the obligations that are developed in the agreement. The provisions on dispute settlement would be developed bearing in mind dispute settlement mechanisms in other fora.

While the MAI would be a stronger instrument if it provided for effective settlement for both investor-to-state and state-to-state disputes, the scope and application of such a provision are still to be decided. A question remains to what extent decisions relating to the establishment phase of investment can be referred to the state-to-state dispute resolution mechanism of the agreement. Another issue is whether an investor can bring a claim against a state for the breach of a liberalisation obligation regarding establishment. It would also be necessary to address the question of the application of dispute settlement provisions to REIOs.

There are other issues relating to both investor/state and state/state dispute settlement which are of a more technical nature and for which there are ample precedents in BITs and other investment agreements. Some further work may need to be done on these questions which include: the scope of application of the dispute settlement provisions, the conditions for bringing dispute settlement (such as time limits/exhaustion of local remedies), how to provide for consent by the state, the avoidance of forum shopping, the forum for arbitration, consolidation, enforcement, and available remedies.

A single, broad, asset-based definition of investment in the agreement would offer the most comprehensive coverage. However, it remains to be determined how in fact the definition would be applied for the different obligations under the agreement, including dispute settlement. The taxation issues relating to dispute settlement under the agreement are being studied together with the Committee on Fiscal Affairs.

Non-Members and Institutional Matters

The MAI would be open to accession by those non-Member countries that are ready and able to take on the obligations of the agreement on terms and conditions to be agreed by all the contracting parties. Informal channels of communication are needed to exchange information as discussions proceed. The mechanism for accession to the MAI would allow the parties to preserve a satisfactory balance of commitments.

The prevailing view is that the MAI would be a free-standing agreement with links (still to be defined) to the OECD. The OECD would be responsible for supporting the functioning of a “parties group” where OECD and non-OECD countries that become parties to the agreement would participate on an equal footing. The OECD Agreement on Normal Competitive Conditions in the Commercial Shipbuilding and Repair Industry provides some indications of the role that such a group could have.

As regards the relation between the MAI and the OECD instruments, there will be political choices to be made, as well as some technical/legal questions. For the OECD Codes for Liberalisation, the assumption is that a MAI would cover (as a minimum) obligations on investment in the establishment and post-establishment phase, all associated capital flows, and the free transfer of income from capital (including interest, profits, dividends, and rents). What this implies for the Codes would be addressed in the context of the negotiations.

Similarly, the questions of what happens to the different elements of the 1976 Declaration and Decisions on International Investment and Multinational Enterprises depends on what is ultimately included in a MAI. Certain elements, particularly the OECD Guidelines for Multinational Enterprises, could be incorporated as separate annexes, with references in the preamble to the MAI, depending on how the matter was treated under the MAI. This leaves open the question of the status of the relevant Council decisions on procedural matters and whether and how to associate non-Members with these decisions.

With respect to other (non-OECD) international agreements, bearing in mind the relevant legal rules on successive treaties on the same matter, a MAI should avoid conflicting obligations and allow better treatment for the investor to prevail. The degree of overlap, and therefore any potential conflict, can only be determined once the MAI obligations have been defined. However, the relation between a MAI and taxation agreements, as well as its interface with the GATS, TRIMS, and TRIPS agreements require special attention together with trade and fiscal experts. Results of negotiations completed elsewhere, such as specific service areas and their related provisions in the GATS, would be taken into account.