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# Reservoirs of the Future

Karl P. Sauvant, *Columbia University*



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# Reservoirs of the Future

*Monitoring new and emerging reservoirs of foreign direct investment and identifying ways and means to strengthen the development impact of such investments is not an easy task. It may require investment promotion agencies to strengthen their policy advocacy role within their own governments, with a view to helping improve the investment climate – not only for foreign, but also for domestic investors.*

## **Karl P. Sauvant**

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More and more firms have become transnational. For developed countries for which time-series data are available, the number of transnational corporations (TNCs) rose from 7,000 in 1968/69 to close to 40,000 in 2003; the total number of TNCs worldwide is today easily above 60,000. And firms that are already established abroad transnationalize further. Not surprisingly, therefore, world FDI flows have risen dramatically: from some US\$40 billion at the beginning of the 1980s, to US\$610 billion at the end of 2004; FDI outflows from developing countries today are already higher than world FDI flows were 25 years ago.

And there is no reason why FDI flows should not increase further, and substantially so. Worldwide, they account for 10 percent of gross domestic capital formation, but in some countries (UK, Singapore) they are quite high. The supply of FDI is not fixed – it is a function of three basic factors:

1. Progress in technology – which makes it increasingly easy for firms to operate international production networks. In this regard, computer-communication and transportation technologies have been particularly important in recent times.
2. The continued liberalization of FDI regimes and the strengthening of standards of protection of foreign investors through international investment agreements – which create the space into which firms can expand with security. This liberalization trend is pervasive: between 1991 and the end of 2003, nearly 1,900 changes of FDI frameworks took place in some 150 countries, 95 percent of which went in the direction of creating a more welcoming investment climate. These changes at the national level are complemented by international investment agreements. The number

of bilateral investment treaties alone had risen to nearly 2,500, by the end of 2004, and virtually all new free trade agreements are also free investment agreements.

3. Competition among firms – which drives them to take advantage of the opportunities offered by technology and liberalization in order to increase their international competitiveness by establishing a portfolio of locational assets, i.e. to undertake FDI.

To be sure, the expansion of the growth of FDI does not necessarily have to continue. For one, although the trend has been vigorously upward for the past 20 years or so, there were FDI recessions. There was a small one in the 1990s, and a big one – a virtual FDI bubble that was deflated – at the beginning of this decade, when FDI flows collapsed from US\$1.4 trillion in 2000 to US\$580 billion in 2003; only now are we coming out of this recession. These breaks in the trend were largely the result of an unfavorable overall economic performance, as economic growth is one of the principal determinants of FDI flows. Investment flows in the future will also be a function of economic growth, at least to a large extent (*see Chart 1, page 99*).

But there are other risks, too. Chief among them is the attitude towards FDI. We need to remember that, only 30 years ago, many countries saw FDI as part of the problem, so to speak, as far as economic development was concerned and, therefore, restricted inflows. Since then, the pendulum has swung dramatically: FDI has become part of the solution to economic development. Some countries in fact appear to place too much store in FDI, forgetting that, as a rule, it is only a complement to domestic investment or perhaps also a catalyst.

We cannot exclude that attitudes change again. A backlash could be fuelled by disappointed expectations, disillusionment with certain aspects of globalization and/or a greater assertion of national identity. The question “Who is us” asked so famously by Professor Robert Reich 20 years ago is after all still with us today, in developed as well as in developing countries. As a result, the second basic factor mentioned above (the FDI liberalization trend) may come to a halt (or even be reversed) and be replaced by investment protectionism, with implications for the opportunities available for investors and hence also the competitive pressures on firms to take advantage of them.

For now, however, firms expect to invest more abroad, and all countries, without exception, seek to attract FDI, as an important ingredient of economic growth and development. And they do so with growing vigor: red carpets are replacing red tape everywhere.

The great majority of countries now have investment promotion agencies (IPAs), often also at the sub-national level. Many were established during the past decade or so, and more will be established in the future, substantially increasing the number of players seeking to attract investment. Indicative is the number of members of the World Association of Investment Promotion Agencies (WAIPA) which has risen in 10 years to 178 in August 2005, from 146 countries. And there are many more “out there” that are not members; China alone has some 200 at various administrative levels.

Hand in hand with the proliferation of IPAs, there has been a rise in investment incentives. Countries think that, through such incentives, they can compensate for locational weaknesses or otherwise tilt the balance of an investment decision in their favor – not withstanding that, in most cases, incentives are only icing on the cake

for investors. Still, as in the area of military disarmament, the containment or reduction of incentives is probably only possible if it is done on a regional or global basis. For the time being, however, such an investment incentive control regime is not in the cards. Some fear therefore a race to the sky for financial and fiscal incentives, and a race to the bottom for regulatory incentives.

Investment promotion is also becoming more sophisticated. The great majority of countries has moved from just liberalizing their investment regimes and opening up to such investment to a second generation of investment promotion in which they have established IPAs that actively promote their countries as investment locations. “Marketing a country” is the watch-word. Moreover, an increasing number of IPAs is complementing their first and second generation investment promotion strategies with embarking on a third generation strategy: targeting. By focussing on specific countries, industries, investors, companies or activities, IPAs expect to get more “bang for their buck”, especially in light of their countries’ comparative advantage and development goals, but also in light of the limited resources they typically have available. This targeting approach will become more prominent in the future – and calls for the identification of niche FDI markets.

The upshot of all of this is that more IPAs will be chasing every FDI dollar, making for fierce competition among countries. So where in this highly competitive world FDI market will the future FDI dollars come from? What are the FDI reservoirs of the future? Where should IPAs look for them?

First of all, of course, IPAs need to continue to look into all those areas to which they have traditionally paid attention, as these will remain investment reservoirs, e.g.

developed countries, manufacturing, natural resources, and existing investors. Already established investors, in particular, remain key, as reinvested earnings account for a sizable share of FDI inflows. This makes after-care services especially important, as a satisfied foreign affiliate is a country’s best investment ambassador. (Even poor IPAs can deliver such services without major expenses.)

*“The FDI liberalization trend may come to a halt (or even be reversed) and be replaced by investment protectionism.”*

Beyond that, there are a number of areas that deserve more attention than they have typically received so far. In what follows, I identify two broad-based FDI opportunities and three niche FDI markets (some of which will become big over time). Looking beyond broad-based opportunities – where all are players – and focussing on niche markets may mean less competition from other IPAs, and it may involve some first-mover advantages. IPAs that have embarked on the third-generation investment promotion strategy, in particular, need to know where targeting opportunities exist.

#### **Services – Where the Action Remains**

In developed countries, the services sector accounts for over two-thirds of Gross Domestic Product (GDP), in developing countries over half. Moreover, most services are (not yet) tradable: they need to be produced when and where they are consumed. Hence, they can be brought to foreign markets only through FDI. At the same time, services firms have built up the firm-specific advantages that allow them to compete successfully abroad.

And they have started to do so, with a vengeance.

Over two-thirds of FDI flows are now in the services sector. As a result, the composition of the FDI stock has shifted dramatically: while only one-fifth of this stock was in services in the early 1970s, it is now three-fifths.

The action is likely to remain in services. While entry into manufacturing has largely been liberalized in most countries, the same cannot be said for many services. Liberalization, deregulation and privatization are bound to open up more services to FDI. The new opportunities will bring more players into the FDI market (including firms that have been privatized) and entice existing ones to transnationalize further. They still have some way to go if they want to catch-up with their manufacturing counterparts which, in terms of the share of foreign assets in total assets, are about twice as transnationalized than services firms.

Moreover, all manufacturing and natural resources firms also undertake substantial service activities, from marketing, to accounting to Research and Development (R&D); if conditions are right, a part of these activities are also candidates for FDI. Finally, third world TNCs typically begin to transnationalize by making trade-supporting investments. All these factors combine to suggest that services will remain the main source of FDI, perhaps becoming even more important.

How to capture this potential? First and foremost, by recognizing that industrial FDI, while certainly important, constitutes only a relatively small share of the total. While the need to shift focus may appear obvious, many IPAs still think of FDI mainly in manufacturing terms. In other words, IPAs need to focus more on services firms.

As services are typically more regulated than manufacturing, services investment policy reviews may be of help to determine a country's potential to attract services FDI and how this potential can be realized. Where key

service industries (banking, insurance) are involved, however, countries need to keep in mind the need for prudential regulation. In the case of privatizations (especially of infrastructure projects), furthermore, the do's and don'ts of privatization need to be observed, lest a public monopoly be replaced by a private (foreign) one.

#### **Offshoring – Wave of the Future**

If services are the driving force of the current wave of FDI, offshoring will power the next. In particular, computer-communication technology is making information-intensive services (and they are the bulk) tradable. In other words, it is no longer necessary to produce these services when and where they are consumed. Rather, they can be produced in one place and then consumed (later) in another place.

This tradability revolution opens entirely new opportunities for the production of services: the production process can be split up, and individual services or service components can be offshored – they can be produced where in the world the conditions are best for their production. What this means is that, as in manufacturing, an international division of labor is becoming possible, leading to a major shift, a new international division of labor, in the production of services worldwide. The reservoir for this is huge given that this possibility has only been created recently due to technological advances, that services account for the bulk of economic activity and that a good part of the activities of industrial firms consists of services.

Moreover, the regulatory framework for trade in offshored services is open, i.e. companies are free to trade their offshored services internationally. True, there has been some concern, especially in the US, about what off-

shoring means for the home country and especially its labor market; but so far these concerns have not taken hold. This may change, however, as offshoring gathers speed (and it is likely to be a much faster process than in the case of manufacturing); the magnitude of the phenomenon becomes apparent; if white-collar workers lobby against it and the adjustment process in home countries is too slow.

Given this new possibility, few firms can ignore it if and when their competitors can realize substantial competitive advantages through the offshoring of some of their services. (Many firms have in fact already taken the first step, by outsourcing certain services within their own countries; to do so internationally is the next step.) In fact, for those that offshore, all the advantages of an international division of labor come into play, not only lower wages (which may trigger the process), but also possibilities to access skills, create economies of scale, etc. So far, firms from the US and the UK have taken the lead, with the majority of the world's top 1,000 firms barely having joined in. But then we are only at the beginning of the tradability revolution, although competitive pressures are likely to ensure that the tipping point will be reached soon.

Naturally, services can be offshored to third parties (and a good part is done this way), i.e. it does not involve FDI. But a good part does – and FDI will become more important the more sophisticated the service activity involved is and the closer it is to the core competencies of the firms doing the offshoring. Thus, as the international production of services is being reorganized, IPAs can tap a huge potential – and not only IPAs from developing countries, but also from developed ones, and economies in transition. For, as in the geography of manufacturing

FDI, various factors determine the location of offshored services investment, with the result that, at the moment, roughly half of the new offshored services projects are located in developed countries and half in developing ones. In principle, every country can get a piece of the action – provided the conditions are right.

How to get in into the action? The first thing is to be pro-active. Many firms do not yet understand the new world of offshoring. They need to be approached. Moreover, intermediaries are springing up to help them identify services that can profitably be offshored and, also, to advise them where to go; they need to be contacted or retained.

Of course, the challenge is to match a country's comparative advantage with the needs and strategies of investors. That may involve specific actions like offering certain skills, strengthening the telecommunication infrastructure and promulgating data-protection laws. Special attention needs to be given to after-care, including to get foreign affiliates to convince headquarters to consolidate their offshored services in your location. In brief, this is an opportunity that is up for grabs.

### **Emerging Market TNCs**

Beyond the broad-based opportunities of services and offshoring (which, in any event, are interlinked), a number of niche FDI markets exist that deserve special attention, especially by IPAs that pursue third-generation targeting strategies.

Emerging market TNCs are very much in the news these days, especially because of a number of high profile takeovers (or attempts to do so) and greenfield investments by Chinese firms abroad. Certainly, outward FDI from emerging markets (all non-OECD countries) has risen

sharply, but developed countries remain by far the most important source of FDI. Still, the amounts involved are already considerable: in 2003, outflows were about US\$50 billion and the outward stock stood at US\$930 billion. Moreover, even though emerging markets are typically capital importers, over 120 of them reported FDI outflows in 2003. Firms in the BRICs (Brazil, Russia, India, China), in particular, are poised to join their counterparts from countries such as Chile, Mexico, Malaysia and Singapore to become significant players in the world FDI market.

*“Over two-thirds of FDI flows are now in the services sector. As a result, the composition of the FDI stock has shifted dramatically: while only one-fifth of this stock was in services in the early 1970s, it is now three-fifths.”*

Outward FDI from emerging markets will grow significantly since their firms are subject to the same pressures of globalization as their developed country competitors. Hence, they too need to acquire their own portfolios of locational assets as an additional source of their competitiveness. They are increasingly helped in this by their governments: in spite of the policy dilemma in which most emerging markets find themselves by virtue of being capital importers and not exporters, an increasing number of governments is liberalizing their outward FDI regimes (and some of them are actively encouraging such investment), precisely not to handicap the international competitiveness of their firms.

What this means for IPAs is that, increasingly, they need to cast their eyes towards the most important of these emerging outward investors. (For example, a number of IPAs have established offices in China.) Some of

these also have institutions responsible for outward FDI; it may be useful to cultivate relationships with them.

### **Clean Development Mechanism**

The Kyoto Protocol entered into force in early 2005, making it mandatory for developed countries signatory to it to reduce their CO<sub>2</sub> emissions. The European Union has identified over 10,000 industrial installations that must limit their greenhouse gas emissions within the given time-frame; failure to do so will result in considerable fines. Japan has set up the Japan Carbon Financing Corporation to assist Japanese firms abroad in this respect.

As part of the Protocol's Joint Implementation Mechanism, the Clean Development Mechanism (CDM) gives financial credit to firms (and, by extension, their home countries) for reduced CO<sub>2</sub> emissions they bring about in emerging markets. Such credits can save 5 percent or more of the costs of an investment project – not an insignificant incentive. The CDM is particularly relevant in such industries as energy, mining and various processing industries. A few countries (especially Brazil, China, India) are already experimenting with CDM projects.

This niche market is brand-new. IPAs that wish to exploit it need to familiarize themselves with the CDM and especially the conditions under which a project qualifies for it. Countries also need the institutional set-up to handle such projects. After that, those firms in developed countries that need to reduce their CO<sub>2</sub> emissions need to be targeted, provided of course the host country can meet the needs of potential investors. The investment potential of the CDM is considerable.

### **SMEs**

Most TNCs are actually small and medium-sized enter-

prises (SMEs). They account for the overwhelming number of firms in all countries. Yet, they account so far only for a small share of outward FDI. (In the case of Japan, this share is relatively high.) But they are subject to the same competitive pressures of globalization as their big counterparts; and they benefit also from the developments in technology and liberalization. Hence, they constitute an important reservoir for future FDI.

The problem is, of course, that, because they are so numerous, they are difficult to reach and to target. But it is not impossible. Different tools are required, such as credible investment guides. Also, IPAs may need to cooperate with industry associations in key home countries, especially in industries that are important for their development. Road shows focussing on such associations, as well as flagship SME investors, may also be of help here. And, more basic, IPAs must make it known that they are actively courting SMEs, not only the “big boys”. Moreover, SMEs typically face special problems, including of a financial and regulatory kind. IPAs need to see how they can facilitate things in this respect, e.g. by offering co-financing.

### Monitoring Emerging Opportunities

These are some broad-based and specific FDI opportunities of the future. There are others that need to be kept in mind. I simply list them, in no particular order, and without elaborating.

1. The boundary line between what the government does and what the private sector does is changing constantly. At the moment, the role of the private sector is expanding into such areas as education, health care, prison management, roads and waste management. While some of them may be sensitive for some countries, FDI can be found in most of them. IPAs

need to monitor what governments are doing, and be ready to move once the opportunity arises.

2. The infrastructure needs of many countries are considerable, often representing a bottleneck for further economic growth. Yet, a number of firms are prepared to undertake FDI in this area. However, care needs to be taken so that, on the one hand, firms do not exploit monopolistic situations and, on the other, that the risks involved in such long-term investments are mitigated. As regards the latter, new mechanisms developed in the context of public-private partnerships may be of use.
3. Globalization puts pressure on many long-established clusters of tightly interlinked firms in developed countries. If some firms in such clusters lose competitiveness and close down or move out, the entire cluster is in jeopardy. Clusters hence may have to transnationalize or die. Perhaps one can identify clusters that are in jeopardy and see whether entire cluster can be attracted to a particular host country. Cooperation between the relevant IPAs of the host and home countries could be helpful here.
4. The proliferation of free-trade agreements creates new locational situations, and production facilities in one country may be consolidated into those in another. Corporate strategies play an important role here. As such agreements are being concluded, IPAs need to evaluate the opportunities to which they give rise.
5. As societies get richer and the leisure class expands, ecotourism and tourism to special theme parks become more popular. If a host country has the right conditions for tourism, TNCs could be interested to develop them.
6. Many donor countries are concerned about the effectiveness of their official development assistance (ODA). IPAs could explore possibilities to link ODA to major



projects in which foreign investors could play a role, leveraging ODA in this manner and making a given project more attractive. It may also be possible to leverage venture capital funds.

7. Another form of capital that can be leveraged is human capital – of particular importance as economies become more and more knowledge-based. If, for example, a country succeeds in attracting a world-renowned chemist to be affiliated with a local university, chances are that a knowledge cluster develops which, in turn, attracts foreign direct investors and venture funds to such high value-added activities as R&D.
8. There are many firms that have undertaken FDI, but not much of it. With some encouragement and cooperation, such low-intensity TNCs could perhaps be convinced to transnationalize further. The same applies to firms that are still entirely national, either because they have not ventured abroad or because they had been, until recently, public entities that operated only at home. And as more firms are “born global” or rapidly become TNCs, IPAs need to keep an eye on such newcomers. In this context, one should keep in mind that many of the benefits of FDI can also be obtained through various non-equity forms of transnationalization (although these may well lead, eventually, to investment relationships); IPAs may wish to encourage such non-equity arrangements as well.

Identifying investment reservoirs of the future requires a constant monitoring of trends and opportunities in the world FDI market and of corporate strategies. Going after investors pursued by everyone else is a necessity, especially if they account for the bulk of FDI. But increasingly IPAs have to be on the lookout for niche FDI markets that

match the locational advantages of their economies and their own “unique value propositions”.

What is more, IPAs need to do that without losing sight of the ultimate objective that FDI is meant to serve, namely to contribute to economic development and well-being of a host country’s society. Keeping this development function of IPAs in mind will become increasingly important in the future, especially if the attitude towards FDI should again become more sceptical. Apart from seeking to attract FDI, IPAs will need to pay more attention to enhancing the positive developmental impact of such investment.

In the end, though, an African proverb may well capture best the competition that characterizes the world FDI market: “Every morning, when the lions wake up, they know they have to run faster than the slowest gazelle not to go hungry in the evening. And every morning, when the gazelles get up, they know they have to run faster than the fastest lion to survive.” I guess the moral of this proverb is that it does not matter whether you are a lion or a gazelle – an IPA or a TNC: when you get up in the morning, you better run as fast as you can!

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*Dr. Karl P. Sauvant* recently retired as the Director of UNCTAD’s Division on Investment, Technology and Enterprise Development (DITE). He has been the team leader of the prestigious annual United Nations publication the World Investment Report since he created it in 1991. He is also the Editor-in-Chief of the journal *Transnational Corporations*. Apart from his work for the United Nations since 1973, he has published extensively on issues related to economic development, FDI and services. His name has been associated with some 150 United Nations publications on FDI over the past two decades. A native of Germany, Dr. Sauvant received his Ph.D. degree from the University of Pennsylvania, Philadelphia, USA.

# What's Next? Strategic Views on Foreign Direct Investment

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