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Global and regional FDI trends

from

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In order to make my presentation on: “Global and regional FDI trends” I will focus on the following two broad trends, weaving in policy implications where appropriate:

- The rapid growth of foreign-direct-investment (FDI) flows and the diversification of sources of FDI in terms of home countries, firms and sectors. This is the supply side of the story, so to speak, dealing with the push factors of FDI.

- The growing efforts of host countries to attract FDI. This is the demand side of the story, so to speak, dealing with the pull factors of FDI.

Let me mention also that my presentation is largely based on work done in the context of the World Investment Report series, our annual analysis of developments in the world with respect to FDI and transnational corporations (TNCs). (Incidentally, the World Investment Report 1999 deals with FDI and development).

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I. The growth of FDI flows and the diversification of their sources

During the early 1980s, world FDI inflows amounted to about $50-60 billion a year. In 1997, they were $414 billion, of which $160 billion alone went to developing countries. A good part of this FDI consists of “sequential” and “associated” FDI. “Sequential” FDI is undertaken by foreign affiliates that are already established and consists mostly (but not only) of reinvested earnings. “Associated” FDI is FDI that is triggered by the establishment of affiliates or the expansion of existing foreign affiliates; it is typically undertaken by supplier or rival firms that follow a leader into foreign markets. In the case of suppliers, the relationship can become so close that they are virtually integrated into the lead firms’ foreign affiliates.

These figures on FDI flows do not include funds raised locally or in international markets, implying that the actual size of international production is actually more substantial; and, of course, they do not capture the numerous non-equity relationships (including alliances) that TNCs enter into, and that bring with them many of the same benefits that are part of the FDI package. Still, they show that FDI has grown considerably during the past 15 years and particularly rapidly since the mid-1980s (with one two-year interruption at the beginning of the 1990) -- more rapidly indeed than GDP, trade and gross domestic capital formation.

The result is a world FDI stock of about $3.5 trillion (at book value). It generates sales by foreign affiliates estimated in 1997 to be about $9.5 trillion -- compared with world exports that year of $6.4 trillion. In other words, FDI is more important than trade in terms of delivering
goods and services to foreign markets (in the case of the United States, incidentally, by a factor of two) and, hence, linking markets internationally.

But FDI is not only a mechanism to link *markets*, it is also a mechanism to link the *production systems* of countries internationally. In the past, this linking of production systems through FDI was not very pronounced, as most TNCs pursued stand-alone strategies, in the framework of which foreign affiliates were largely autonomous units, only loosely integrated into the TNCs' overall corporate networks. Today, however, an increasing number of TNCs is pursuing complex integration strategies that are characterized by a vertical and increasingly horizontal international intra-firm division of labour in which any part of the value-added chain can be located abroad, while remaining fully integrated into TNCs' corporate network. Complex corporate integration strategies seek to exploit regional or global economies of scale and a higher degree of functional specialization. The results are integrated international production networks at the firm level. The aggregation of these production networks, in turn, leads to the emergence of an integrated international production system -- the productive core of the globalizing world economy.

This linking of the productive systems of countries represents deeper integration than that achieved by traditional arm's length trade. Unlike trade -- which normally involves one-off transactions of goods and services -- FDI, by its very definition, involves the establishment of lasting relationships that engage the factors of production of the countries involved. At the same time, the corporate networks that are being established in the process can serve as conduits
between countries -- not only for capital, but also for technology, know-how and skills, as well as for imports and exports. In fact, intra-firm trade accounts for about one-third of world trade, with another third also undertaken by TNCs.

The relationship between FDI and trade is, of course, complex. Traditionally, it is discussed in terms of whether FDI leads to trade; or trade leads to FDI, or whether the two are complementary to each other. Increasingly, however, the fact that, within their corporate strategies, any firm -- be it transnational or national -- can decide to locate any part of its value-added chain wherever it is best for it to convert global inputs into outputs for global markets, means that FDI and trade flows are increasingly being determined simultaneously. They are both immediate consequences of the same locational decision. The question therefore becomes more and more, no longer whether trade leads to FDI or FDI leads to trade; whether FDI substitutes for trade or trade substitutes for FDI; or whether they complement each other. Rather, it becomes: how do firms access resources -- wherever they are located -- in the interest of organizing production as profitably as possible for the national, regional or global markets they serve? In these circumstances, the decision where to locate is a decision where to invest and from where to trade. And it becomes a FDI decision, if a foreign location is chosen. It follows that, increasingly, what matters are the factors that make particular locations advantageous for particular activities, for both, domestic and foreign investors.

The policy implications of these broad developments are equally broad: with FDI having become the major mechanism through which countries are linked to, and integrated
into, the world economy, policy makers need to look at international economic relations increasingly from a FDI angle, and no longer only — and perhaps not even primarily — from a trade angle. This, in turn, needs to be reflected in the formulation of national policies and the priorities set at that level.

At the same time, given the interrelationships between FDI and trade, governments need to take care that their national policy frameworks for FDI and trade are consistent with each other. Inconsistent policies risk creating an environment in which trade and FDI policies may neutralize each other, or could even prove counterproductive. On the other hand, when formulated and implemented coherently, these policies become mutually reinforcing in support of national growth and development.

When it comes to FDI proper, the developments over the past decade have shown that the global supply of FDI is quite elastic. In fact, we do not know what the limits of this supply are. Given that FDI world-wide represents only 6 per cent of gross domestic capital formation (9 per cent for the developing countries as a group), it may well be that FDI flows could reach substantially higher proportions (and levels). Another policy implication is therefore that countries or groups of countries having an attractive investment climate ought to be able to attract significantly higher amounts of FDI flows than they do now.

Compared to the past, moreover, countries can attract such flows now from a much more diverse group of countries. During the 1970s, two countries (the United States and the United
Kingdom) had FDI outflows of $3 billion or more; in 1997, 19 countries had FDI outflows of $3 billion or more. Today, these include all larger developed countries.

Significantly, while there was no developing country in that group during the 1970s, it now includes 4 developing economies, all from Asia (China; Hong Kong, China; Republic of Korea; Taiwan Province of China). The growing importance of developing countries as home countries is, of course, also reflected in their share in world FDI flows, a share that increased from 1 per cent during 1970-1979 to 13 per cent in 1997. Most of these flows remain within the geographical region of the (developing) home country. In developing Asia, they have assumed significant proportions: some 40 per cent of inward FDI consists of outward investment by other developing Asian countries.

This substantial diversification of home countries reflects, of course, the fact that more and more firms in these countries have become transnational. Indeed, we estimate that there were 7,000 TNCs in 14 of the most important home countries at the end of the 1960s; by the middle of the 1990s, this number had increased to 37,000. Worldwide, we estimate that there are at least 53,000 TNCs (defined as firms of any size controlling assets abroad), having about 450,000 foreign affiliates. The number of foreign affiliates per TNC has also risen -- from around 4 at the beginning of the 1990s to about 8 in the middle of this decade.

Most of the largest of these TNCs are, not surprisingly, headquartered in the developed countries. In fact, 98 companies on UNCTAD’s 1995 list of the world’s largest 100 TNCs in
terms of the size of foreign assets are located there. But developing country TNCs are not far behind. In fact, two developing country TNCs entered the list in 1995. In UNCTAD’s separate list of the 50 largest developing country TNCs, 31 are headquartered in Asia.

The number of 53,000 TNCs also draws attention to the fact that, obviously, this number includes many small and medium-sized enterprises (SMEs). This is not surprising: in a world economy in which barriers to FDI, trade and technology flows have been reduced remarkably, and technology makes the management of far-flung affiliate networks possible, SMEs, too, discover that there are no profit reservations and market niches that remain protected from the fierce winds of global competition. In a liberalizing world economy, indeed, competition is everywhere. SMEs too, therefore, recognize that a portfolio of locational assets is increasingly necessary to supplement their portfolio of proprietary assets and human resources as principal sources of efficiency and competitiveness -- and, hence, they move abroad. Japanese SMEs are leading in this respect, contributing between 10 to 20 per cent of Japan’s outward FDI. In other home countries, however, SMEs are a reservoir for FDI that has barely been tapped.

But it is not only that more smaller firms become TNCs, they now hail from virtually every industry. However, the sectoral structure of FDI flows has changed dramatically: while some 30 years ago most FDI was in natural resources and manufacturing, today about half of the world’s FDI stock and perhaps close to two-thirds of FDI flows are in services -- ranging from banking and trade to roads and hospitals. This does not mean, however, that firms in all three sectors are equally transnationalized. In particular, all indications are that, on average, services
firms are considerably less transnationalized than industrial firms, perhaps only half as much. Since most services still need to be produced where they are consumed, this means that services firms, if they wish to conquer foreign markets, typically do not have the choice to use exports. Rather they need to establish themselves in these markets, normally by creating affiliates that, in many ways, are as capital and skill-intensive as their parent firms. At the same time, the increased tradability of services via international computer-communication networks means that services firms, too, can begin to establish an international intra-firm division of labour within which the production of tradable (i.e., information intensive) service components can be moved off-shore. (The same is, in fact, happening with information-intensive services produced and used by goods-producing firms.) Thus, the services sector -- and, more broadly, services activities -- represents another important reservoir for FDI that can be tapped.

More generally, a growing number of firms in an increasing number of developed and developing countries, and in virtually all industries, are TNCs, and many more are likely to become TNCs. Moreover, probably all of those firms that control already assets abroad can increase their transnationality, and are likely to do so. This means not only increased FDI flows, but also increased competition among TNCs for profitable investment opportunities -- be it through mergers and acquisitions, the establishment of greenfield facilities or the acquisition of assets in the framework of privatization programmes.

The policy implications of these trends are fairly straight forward: developing countries that seek to attract FDI need to cast their nets much wider than in the past to
reach potential investors. In particular, apart from pursuing traditional investors in traditional home countries, they need to target non-traditional investors and non-traditional home countries. In both cases, furthermore, they need to scout firms in virtually every industry, including firms that are little or not at all transnationalized. This scouting increasingly has to target SMEs and firms in the services sector as well. And, in light of the fact that any part of the value-added chain is potentially a candidate for production abroad, these efforts should not only be undertaken with the objective in mind to attract “clones” of the parent corporation; rather, these efforts need to be focussed increasingly on individual corporate functions of both industrial and services firms.

In pursuing such a course, IPAs may find it particularly useful to cultivate investors in their own region, given the importance that regional TNCs have already obtained.

This line of thinking may have a logical -- albeit unusual -- extension. Governments traditionally maintain embassies in the capitals of the countries that they consider important for them politically. Perhaps governments should also consider maintaining a presence at the headquarters-locations of firms that are important for them economically, precisely to cultivate relations.

II. Growing efforts of countries to attract FDI

If the supply of FDI has increased and become more diversified, so has the demand for
such investment. Some 20 years ago, many countries had reservations as regards FDI and excluded or restricted its inflow. Today, every single country seeks to attract FDI, in many cases not only at the national level but also, and independently so, at various sub-national levels. Typically, these efforts to attract FDI take two forms: liberalization and promotion.

1. **Liberalization**

   The establishment of a liberal framework for FDI involves the reduction of barriers to entry and operations by foreign investors; the strengthening of standards for their treatment by host countries (with national treatment perhaps being the most important among them); and the strengthening of mechanisms that ensure the proper functioning of markets. The bulk of the efforts in this respect take place at the national level: in 1997 alone, 135 out of 151 changes in the FDI regimes of 76 countries went in the direction of greater liberalization (or promotion). If one takes the period 1991-1997 as a whole, only 43 out of 750 FDI policy changes went into the direction of greater control.

   These unilateral national efforts at liberalization are complemented by facilitation and protection efforts at the bilateral level, where the principal instruments are double-taxation treaties and bilateral investment treaties (BITs). By the end of 1997, there were 1,794 BITs in existence, two-thirds of them concluded during the 1990s. Some 178 countries participate in them, including, increasingly, developing countries concluding BITs with other developing countries.
At the regional level, too, governments seek to improve the framework for FDI flows, especially in the context of the European Union, NAFTA, the Lomé Convention, APEC, MERCOSUR and ASEAN. This reflects the recognition of governments that FDI is attracted by large markets. In fact, today’s regional agreements are really no longer only free trade agreements but more and more free investment agreements as well. Perhaps most ambitiously, the OECD embarked in 1995 on negotiations aimed at enshrining high FDI standards in a Multilateral Agreement on Investment; these negotiations were however discontinued.

Finally, there are a number of multilateral instruments that bear on FDI and, as you know, there are discussions on the interrelationships between trade and development underway in the WTO.

There is one aspect of the liberalization trend that has received little attention so far, namely the liberalization of policy regimes governing outward FDI. Countries often seek to attract FDI with a view to contributions to growth and development. Outward FDI can serve the same objective by enhancing access to markets and resources and, more generally, subjecting national companies to the rigors of direct participation in international markets and production. In fact, as mentioned earlier, a portfolio of locational assets is today an increasingly important source of corporate efficiency and competitiveness. Virtually all developed countries have already liberalized their outward FDI regimes; the more advanced developing countries have embarked on a similar course and, in some instances, gone very far with it (especially in South-East Asia). Most developed countries and a number of developing countries (again, primarily in
South-East Asia) have even put various instruments in place that promote or at least protect outward FDI.

Together, these developments signal a powerful liberalization trend indeed. Very often, moreover, and especially in a regional context, this can involve elements of policy competition between countries.

The policy implications arising from this trend are that countries wishing to attract FDI need to establish state-of-the-art FDI frameworks, without, of course, losing sight of the need to ensure that FDI should ultimately serve the national development effort. This may require a comprehensive stock-taking, e.g., in the framework of the Investment Policy Reviews introduced by UNCTAD. These Reviews seek to assess the role of FDI in a given country, the potential for more such investment, the regulatory framework for FDI, and ways to improve it in order to help realize the potential identified.

In any event, the search for an appropriate FDI framework also needs to reach into non-traditional areas, such as the regulatory framework for inward FDI by SMEs; for instance, there may be (perhaps unintended) obstacles that small investors face, or SMEs many need special arrangements. More attention may also be desirable as regards improving the framework for outward FDI; perhaps an exchange of experiences among developing countries that have already liberalized their outward FDI regulatory regimes, and between them and the next tier of liberalizers, would be useful, not only to learn from
each other but also to facilitate investment flows between the countries involved.

But the policy implications arising from the liberalization trend include also that countries have to guard themselves against a "race to the bottom" in their policy competition. They also need to be careful not to pursue policies that end up discriminating against local firms in favour of foreign affiliates, as this would ultimately hurt their development efforts. At the same time, governments need to monitor, emulate and invent "best practices" in respect to FDI, knowing fully that best practices in one country rapidly become "benchmarks" for other governments. And such benchmarking is particularly relevant in a regional context. Cooperation at the regional level is, therefore, beneficial for all countries involved. Such cooperation, where it takes the form of creating larger markets, has the added advantage that, as noted before, they are more attractive to foreign investors than smaller national ones.

2. **Promotion**

The liberalization trend, in turn, is complemented by increasing efforts of countries to promote themselves as investment locations. Such promotion efforts, too, involve a wide array of instruments, ranging from building a positive image, to the provision of information, after-investment services, targeted approaches to investors and the offering of various incentives. The use of all of these instruments has become more routine, pervasive and sophisticated.
This applies also to incentives, where we witness a rapidly escalating incentives competition among counties. In most instances, however, fiscal and financial incentives play only a minor role in the country-location decisions of TNCs because other factors -- especially market size and growth -- are much more decisive. Incentives competition can therefore be largely wasteful, and, where it succeeds, distortive.

In promotion, too, "best practices" need to be monitored, emulated and invented. With the creation of the World Association of Investment Promotion Agencies (WAIPA), which is supported by UNCTAD, UNIDO and MIGA, 101 IPAs (as of April 1999) have now a forum in which they can exchange information and cooperate. This would be particularly important in the area of incentives, as countries ought to consider -- in their own interest! -- how to curtail at least the worst outgrowths of the escalating incentives competition. And this, surely, can be done much better at the regional or sub-regional level than at the national level.

One implication for promotion of the trend identified earlier needs, however, to be singled out. It relates to the importance of "sequential" and "associated" FDI. Given the importance of these types of investment, it can be crucial to any promotion effort (especially in oligopolistic industries) to attract one important investor, be it through a greenfield project, a merger or acquisition or in the context of privatization programmes, precisely because this can set into motion a process in the framework of which a host of suppliers and rivals also decide to locate in the same area. In a sense, it is a process that is
similar to the establishment of a successful shopping mall: if a developer succeeds in attracting one or two well-known “anchor” or “flagship” stores, it is much easier to attract other stores as well.

3. **Systemic competitiveness**

By their very nature, the liberalization and promotion trends discussed so far are confined to a relatively narrow area, namely the immediate FDI framework. But one should not lose sight of the broader investment climate. This is, of course, a broad field and includes the rule of law, efficient administrations, good infrastructure, a good public-private sector partnership and everything that reduces the “hassle costs of doing business”. To the extent to which the immediate FDI framework becomes more similar across countries — as it does — the “systemic competitiveness” of a country’s business sector moves into the foreground as an important consideration for location decisions.

Governments would therefore be well advised to pay increasing attention to the systemic competitiveness of their business sectors. This becomes even more important in countries that have sizable outward FDI flows, as this means that the distinction between domestic investment and foreign investment becomes, for policy purposes, more and more blurred. More specifically, governments need to make it not only attractive for foreign investors to come to their shores; they increasingly need to make it also attractive for domestic investors to stay on-shore. In brief, governments have to create an environment in
which investment — be it domestic or foreign — can prosper. What is more, they have to do this under conditions in which all governments are competing — and are competing fiercely — to do the same, namely to entice their own firms as well as foreign firms to locate production facilities in their territories.

III. A competitive world investment market

More firms from more countries in virtually all industries are investing abroad. All countries, and in many cases provinces and individual municipalities, seek to attract FDI. The world market for FDI is truly global, and it is driven by competition: competition between firms and competition between countries. Given this, it is perhaps appropriate to close with an African proverb: “Each gazelle that gets up at dawn knows that it has to run faster than the fastest lion if it wants to survive. Each lion that gets up at dawn knows that it has to run faster than the slowest gazelle in order to survive.” The point is, I suppose, that it does not matter whether you are a gazelle or a lion: if you want to survive and prosper, you better run as fast as you can.

Thank you very much for your attention.