AIM Investment Report 2015: Trends and Policy Challenges

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AIM INVESTMENT REPORT 2015
Trends and Policy Challenges

In Cooperation with
Dr. Karl P. Sauvant
Columbia Center on Sustainable Investment

Second Edition

Sustainable Development Through FDI Induced Innovation and Technology Transfer
AIM INVESTMENT REPORT 2015
Trends and Policy Challenges

Sustainable Development Through FDI Induced Innovation and Technology Transfer
The second edition of the Annual Investment Meeting FDI Report explores foreign direct investment trends and policy challenges. It presents a comprehensive analysis of FDI in growing markets and provides a remarkable background of information on the growth of FDI inflows and the evolution of FDI policies as well as a thorough analysis of the leading FDI determinants. Research & development and transfer of technology, two major subjects at the heart of our discussions this year at the Annual Investment Meeting, are widely covered with illuminating insights.

Foreign direct investment is more than ever essential to countries’ development, be it developed or developing. Over the past decade, it has grown dramatically as a major form of international capital transfer thanks to an increasingly liberalised and open world economy. More than one third of world trade today takes place in the form of intra-firm transactions - that is, trade among the various parts of the same corporate network spread across borders - and the bulk of technology is transferred within the confines of integrated international production systems. FDI and the operations of multinational enterprises have become central to the world economy at large. Nowhere is this more important than in growing markets.

However, the effect of the global economic crisis continues to impact trade and investment flows and to influence government policy initiatives. In search of new solutions, as the report shows, the year 2014 was characterized by intensive policy discussions, especially about the nature of the international investment law and policy regime, its investor-state dispute-settlement mechanism, the role of bilateral investment treaties, and the question of rules for state-owned enterprises. While the year 2014 saw an interruption in the recovery of world FDI flows in general, emerging markets’ attractiveness as host countries is on the rise, as is outward FDI from these countries, with their multinational enterprises spreading their wings worldwide.

Indeed, the rise of South-South investment among the world’s emerging economies is continuing its upward trend. Fueled by the advance of new economic powers such as China, India, Brazil, or Mexico to name a few, this growing momentum is felt in markets from Africa to South America, spearheading a new era of economic trade and investment flows. The Gulf region plays a pivotal role in this process, not only as significant outward investor but also, in facilitating burgeoning trade connections.

The United Arab Emirates remain committed to develop best practice investment policies through the establishment of a reliable legal framework and environment for the conduct of domestic and international business. Convinced of the power of technology and know-how as levers of growth and advancement, we are also committed to develop a knowledge - based economy through the development of innovation driven activities, designed to stimulate creativity, smart and sustainable infrastructure and vibrant entrepreneurship. As an outward investor, having the largest outward FDI stock in the region, my country is also committed to continue exploring mutually beneficial investment opportunities worldwide and in growing markets in particular. The UAE’s international corporations -- or High-Flyers as we call them here -- are constantly looking for lucrative business opportunities. Some of them have been pioneering clean technology investments or seizing opportunities in the African Telecom markets. Others have been building and managing world class ports and logistics gateways in strategic locations. And again others have been undertaking vast urban and housing developments. The Annual Investment Meeting offers a splendid platform to explore some of these opportunities.

The AIM Investment Report 2015 was prepared by Dr. Karl P. Sauvant, Resident Senior Fellow at the Columbia Center on Sustainable Investment, a joint Center of Columbia Law School and the Earth Institute at Columbia University, United States of America, under his own responsibility. I would like to thank Dr. Sauvant for his most valuable contribution in helping us advance our thinking and understanding about some vital investment issues. I would also like to convey our deep appreciation for the fruitful and productive cooperation established with Columbia University.

I hope this report will be a valuable source for the Annual Investment Meeting community and all governments that are honouring us with their presence, for inspiration, guidance, collaboration, and ultimately development.

We hope you enjoy the report and welcome your continued feedback.

Sultan Al Mansouri
Minister of Economy, United Arab Emirates
In the foreign-direct-investment world, the year 2014 was characterized by policy discussions, especially about the nature of the international investment law and policy regime, its investor-state dispute-settlement mechanism, the role of bilateral investment treaties and the question of rules for state-owned enterprises. This discussion took place against the backdrop of a decline in world FDI flows by multinational enterprises and the growing attractiveness of emerging markets as host countries and the further rise of outward FDI from these countries.

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Resident Senior Fellow, Columbia Center on Sustainable Investment (a joint center of Columbia Law School and The Earth Institute at Columbia University, New York), and Founding Executive Director of the predecessor of that center, the Vale Columbia Center on Sustainable International Investment, and former Director of UNCTAD’s Investment Division. The author would like to acknowledge the helpful cooperation and advice of Valantina Amalraj, Kazuhiro Asakawa, John Cantwell, Henry Loewendahl, Miguel Perez, and Pedro Roffe in the preparation of this report.
CHAPTER 1

GLOBAL FDI TRENDS
CHAPTER 1. GLOBAL FDI TRENDS

A. Trends

The number of firms undertaking foreign direct investment (FDI) has risen substantially over the past few decades. More specifically, the number of multinational enterprises (MNEs) headquartered in 15 members of the Organisation for Economic Co-operation and Development (OECD) rose from 7,300 at the end of the 1960s (with some 27,000 foreign affiliates) to, world-wide, 65,000 around the turn of the century (with around 850,000 foreign affiliates) to, again worldwide, at least 100,000 at the end of 2010, controlling a minimum number of 900,000 foreign affiliates.

The great majority of the largest MNEs are headquartered in developed countries: of the 100 largest by foreign assets, 92 hailed from developed countries in 2013. This reflects the fact that firms from these countries have been investing abroad for decades and, in a number of cases, for over one hundred years.

The foreign direct investment undertaken by these firms amounted to world FDI inflows of US$1.3 trillion in 2014, down from US$1.4 trillion in 2013, for a decrease of 8 percent (figure 1). The year 2014, therefore, saw an interruption in the recovery of world FDI inflows, after they had fallen from the all-time high of US$1.9 trillion in 2007 to US$1.2 trillion in 2009 as a result of the western financial crisis, and then began to recover. The uncertain world economic situation was one of the factors that discouraged investment flows. Given the expected growth of the world economy in 2015, world FDI inflows in 2015 can be expected to rise, although the fragility of the Eurozone and declining commodity prices may dampen prospects.

TABLE 1: The world’s top 100 non-financial MNEs, ranked by foreign assets, 2013

(Millions of US dollars)

1 Defined as firms controlling assets abroad.
5 See, UNCTAD, Investment Trends Monitor, no. 18 (January 29, 2015). These data exclude Caribbean offshore financial centers and FDI flows passing through special purpose vehicles in a number of countries. Unless otherwise indicated, all data in the following paragraphs are from this source or from UNCTAD, World Investment Report 2014: Investing in the SDGs, An Action Plan (Geneva: UNCTAD, 2014).
## Chapter 1. Global FDI trends

Cross-border mergers and acquisitions (M&As) heavily influence FDI flows, as they are the principal entry mode for firms investing in foreign markets (in developed countries more so than in emerging markets). The world’s inward FDI stock reached almost US$ 26 trillion at the end of 2013 – more than thirteen times the world inward FDI stock in 1990. Still, FDI flows account only for a small share of all investment world-wide, namely about 8 percent in 2013, a share that was higher in developing countries (9 percent) compared to developed ones (7 percent).

Most of the world’s FDI flows (US$857 billion or 61 percent) in 2013 (as in past years) originated in the developed countries and, more specifically, in the United States (US$338 billion), Japan (US$136 billion) and Switzerland (US$60 billion) (figure 2). However, outflows from emerging markets continued to grow, reaching US$553 billion in 2013, 39 percent of world FDI outflows. Given this performance of emerging markets, the rise of FDI from this group of countries will be considered separately below.


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7 Basically all countries not members of the OECD, as classified in UNCTAD’s World Investment Report 2014; see, UNCTAD, World Investment Report 2014, op. cit. Basically all countries not members of the OECD, as classified in UNCTAD’s World Investment Report 2014; see, UNCTAD, World Investment Report 2014, op. cit.
8 Since cross-border M&As can be financed from sources other than FDI (and this happens more so in developed countries than in emerging markets), the share of FDI flows that can be attributed to cross-border M&As is difficult to ascertain.
9 The world inward FDI stock was US$2 trillion in 1990.
10 Data on FDI inflows and outflows differ because of different reporting by individual countries.
On the FDI inflow side, the world's various regions fared differently.

Developed countries were largely responsible for the decline of world FDI inflows in 2014: having attracted US$511 billion that year, this represented a decline of -14 percent over 2013. More specifically, inflows into the United States dropped by about one-third (to US$86 billion – see figure 3), on account of a major disinvestment. 11 As a result, the United States lost its place as the single most important host country (which it had held for eight years) to China. (This is an example of the bulkiness of FDI flows: one single M&A can make a substantial difference in the performance of an individual country and an entire region.) A 13 percent rise of inflows into the European Union (to US$267 billion), and a small increase of flows into Japan (to US$10 billion) did not compensate for this decline.


11 Vodafone sold its 45 percent stake in Verizon Wireless to Verizon Communications.
Emerging markets, on the other hand, attracted most (59 percent) of the world’s FDI inflows in 2014, namely US$745 billion – the best performance on record for this group of countries. Specifically, developing countries obtained US$700 billion (56 percent of the total – a slight increase over 2013), while the economies in transition attracted US$45 billion (4 percent - a decrease of slightly over half over 2013). This performance of emerging markets owes much to the slow growth of the Euro area and Japan (at 0.8 and 0.1 percent, respectively, in 2014) on the one hand, and the rapid growth of emerging markets (at 4.4 percent) on the other. \(^{12}\) It is the third year in a row that emerging markets attracted more than half of the world’s FDI inflows.

Among developing countries, the performance of Asia, Latin America and the Caribbean, and Africa was uneven in 2014.

Asia was a dynamo, even if various sub-regions performed differently (box): the region attracted the lion’s share of the FDI flows that went to developing countries, an estimated US$492 billion (or 70 percent of all developing country investment and almost 39 percent of the world’s FDI inflows). This region remains the developing world’s most attractive investment area, with China continuing as the single most important host country: it received US$128 billion inflows, another record; this made China the single most important host country in 2014. Following China were Hong Kong (China) (US$111 billion) and Singapore (US$81 billion). Singapore, given its small size, was a star performer, increasingly attracting regional headquarters. India, on the other hand, remains a distant runner, having received only US$35 billion, far less than China did, and less than half of what Singapore attracted. However, indications are that India’s new government may be more interested in attracting more investment; if this should indeed be the case and action is taken, India could become a major magnet for MNEs. Overall, the dynamism of the region and its leading economies, combined with improving infrastructure and increasingly sophisticated human and technological resources, explain Asia’s performance.

Latin America and the Caribbean was the second most attractive developing country region in 2014, attracting US$153 billion (22 percent of all developing country investment). But the region saw a substantial decline that year, of 19 percent, led by a decrease in Mexico (again mainly influenced by M&As). More generally, the region saw a decline of investment in extractive industries and reduced incoming M&A activity. Brazil, on the other hand, saw inflows of US$62 billion in 2014, in spite of the country’s economic slowdown, as most FDI there is market-seeking. In other words, as in 2013, performance varied widely across the region. That year, South America saw a decline, with inflows decreasing in all major economies except Colombia. Central America, on the other hand, experienced FDI growth, on account of the acquisition of a major brewery company. The end of the mining boom does not augur well for a rise in inflows in the near future.

Africa saw a slight decline in FDI inflows, to US$55 billion in 2014 (4 percent of all developing country investment inflows). The aftermath of the Arab Spring is still playing itself out in North Africa, having led to declining inflows (in the order of 17 percent) in 2014. In 2013, Eastern and southern Africa stood out. Intra-regional flows are becoming more important, driven especially by MNEs headquartered in South Africa. But FDI from other developing countries, especially China, is also playing a role. Importantly, more foreign investment is taking place outside natural resources, if data on the number of new foreign

13 Mexico’s 2013 inflow figures were heavily influenced by the acquisition of one of the country’s foremost companies, Grupo Modelo (a beer company), by Anheuser-Busch InBev (a Belgian beer company managed by a Brazilian CEO). This acquisition inflated the 2013 inflow data, and is reflected in the sharp drop in 2014.
14 See, ECLAC, Foreign Direct Investment in Latin America and the Caribbean (Santiago: ECLAC, 2014).
affiliates are indicative. Service and consumer goods industries have been in the forefront of this development, reflecting the rise of a growing middle class in Africa.

Finally, the economies in transition saw a dramatic fall in FDI inflows in 2014, to the tune of minus 51 percent, to US$45 billion. Russia accounted for the lion’s share of the decline, in light of the conflict surrounding Ukraine and the sanctions imposed on Russia in response.

Moreover, it should be noted that South-South FDI flows are becoming more important. Typically, these take place in a regional context, although interregional flows are also becoming more significant.

Thus, in Africa, South African, Kenyan and Nigerian firms are important investors elsewhere in Africa, with firms headquartered in other African countries also becoming players, especially in neighboring countries. The bulk of this investment is in manufacturing, especially agri-processing, building materials, electric and electronic equipment, textiles, and services (especially banking, retail, telecommunications). Growing consumer markets have spurred this growth. In terms of inward FDI, more than 30 percent of the FDI stock of smaller African countries such as Benin, Burkina Faso, Guinea-Bissau, Lesotho, Rwanda, and Togo originates in other African countries. Several southern African countries received a sizeable percentage of their overall FDI stock from firms based in South Africa. In Africa as a whole, the share of greenfield investments originating from MNEs within the continent grew from 10 percent in 2003 to 18 percent in 2008, and the gross value of investments tripled during this time from less than 3 percent of total investment to more than 9 percent. The continent’s regional integration efforts have helped. But to make a substantial difference, they would have to become much deeper than they are now. Greater regional integration would allow for the pooling of resources and lead to larger markets, which would stimulate investment and production and thus increase prospects for development.

Noteworthy is also growing investment from developing countries from outside the region, especially China. With production costs rising in China’s coastal provinces (where most of the country’s industries are located), labor-intensive manufacturing is beginning to migrate elsewhere, be it production by foreign affiliates or be it production by indigenous firms. Some of this production is moving to China’s central and western provinces and some is moving to other countries in Asia (e.g., Bangladesh, Cambodia, Indonesia, Vietnam). But some light manufacturing is also likely to move to Africa – and there are indications that this is already taking place. In 2013, for example, Huajian Group, an MNE from China, opened its first factory for shoe production in Ethiopia, with plans to establish a $2 billion hub for light manufacturing. The potential for African countries to attract such investment is substantial, as long as the FDI determinants are in place.

In Latin America and the Caribbean, almost all large companies are trans-Latinas. Among the 100 largest developing-country MNEs, 8 are from Brazil, 6 from Mexico, 4 from Chile, 2 from Argentina, and 1 from Venezuela. Oil companies in the region have engaged least in FDI, while raw material processors, such as steel and cement companies, those linked to food and beverages, and telecommunication companies have been the most engaged in outward investment. Most of the trans-Latinas’ investment has remained in the region itself. Firms based in mid-sized economies, such as Chile, Colombia and Peru, have focused on neighboring countries with respect to both greenfield investments and acquisitions. However, they are gradually expanding to other countries in the region. The focus on neighboring countries has been particularly common among service companies. The regional component is also reflected in FDI inflows. Thus, a substantial share of FDI inflows into Colombia, Ecuador, Paraguay, Uruguay, and a number of countries in Central America originates elsewhere in Latin America and the Caribbean.
Companies from Brazil and Mexico, the region’s largest economies, have more significant investments outside the region, mainly through acquisitions in Canada and the United States. Brazilian and Mexican companies have also engaged in acquisitions in the European Union, Africa and Australia. Several Brazilian engineering, construction and mining companies have operations in Africa. This was spurred in part by active diplomacy aimed at enhancing relations with African countries under the administration of President Lula da Silva. From outside the region, Chinese FDI in Latin America and the Caribbean is particularly important: it has been estimated at around US$10 billion annually since 2010 and is remaining steady. This investment is primarily in mining in Peru and oil extraction and manufacturing in Brazil.

South-South FDI flows are particularly important in Asia. In East and South-East Asia, they have been facilitated by ASEAN’s successful economic integration efforts (which have an explicit FDI dimension) and the free trade agreements and international investment agreements ASEAN has concluded with other countries in the region. This regulatory framework would be further strengthened if the negotiations for a Regional Comprehensive Economic Partnership -- launched in November 2012, and involving the 10 ASEAN countries plus Australia, China, India, Japan, the Republic of Korea, and New Zealand – would be concluded successfully. During 2010-2012, the countries negotiating this agreement provided an average of over 40 percent of FDI inflows to each other. A good part of these investment flows is related to infrastructure and manufacturing. As regards the latter, regional value chains (which are an outstanding characteristic of this region), often centered on China, play an important role in Asia’s intra-regional flows. As regards infrastructure, Singaporean and Chinese companies are particularly active. In South Asia, the potential formation of a Bangladesh-China-India-Myanmar economic corridor and a China-Pakistan economic corridor, are likely to increase infrastructure investment in the area (if these projects materialize). China, in particular, has the potential to become a major source of manufacturing and infrastructure FDI in South Asia. Most of Asia’s poorest countries receive a substantial share of their FDI inflows from other countries in the region.

The rise of South-South FDI flows is expected to continue, in particular in a regional context, as developing countries develop further and the international competitiveness of their enterprises increases. This is important for home and host countries. For (developing country) home countries, this is important as the establishment of an international portfolio of locational assets by their firms further strengthens the competitiveness of the investing firms, making these even more formidable competitors in international markets. For (developing country) host countries, the rise of South-South FDI is important as it represents a diversification of the sources of such investment and, therefore, makes them more independent from the vagaries of the world economy. An important implication for investment promotion agencies in developing countries is that they need to look even more than in the past toward other developing countries when they seek to attract FDI – and not only at big countries but also at smaller ones.

B. The importance of the investment determinants

Regardless of the origin of FDI flows, countries seek to attract FDI for one reason and one reason only: FDI can serve as an important complement to domestic investment in building productive capacity to advance growth and development. FDI is a tool for that purpose. But to be successful in attracting such investment, the right FDI determinants need to be in place.

Most important among them are the locational FDI determinants. Among these, the single most important set of factors are the economic determinants, in particular the size and growth of the market, the quality of the infrastructure and the availability of skilled labor and science and technology resources. These factors determine to a large extent the locational choices of firms seeking to invest, as they determine whether or not a given investment location contributes to the international competitiveness of a firm and, hence, ultimately its profitability. The fact that these basic economic determinants have been favorable in much of the developing world in the past few years explains to a large extent the success of these countries in attracting FDI.

Naturally, a prerequisite for any FDI to take place is that the regulatory framework is enabling, i.e., that it allows foreign inward FDI. The regulatory framework, therefore, constitutes a second set of FDI determinants, and it can – and does – influence investment decisions. Virtually all countries have substantially improved their FDI regulatory frameworks over the past two decades, both in their national and international dimensions. But the quality of the regulatory framework needs to be seen against the background of the economic determinants, which are decisive. To put it differently: while the economic determinants are not everything, everything is nothing if the economic determinants are not in place – even if the regulatory framework is exemplary.

22 See, also for the following data in this paragraph, UNCTAD, 2014, op. cit.
Finally, a third set of FDI determinants consists of investment promotion. Up to the mid-1990s, relatively few countries had investment promotion agencies (IPAs). Since then, virtually all countries have established such agencies, and many countries also have sub-national and even city IPAs. According to one estimate, there exist at least 10,000 investment promotion agencies, 23 many competing with each other for investors. Their primary task is, as a rule, to attract as much FDI as possible—which makes for a highly competitive world FDI market.

If and when countries are successful in attracting FDI, the advantage of such investment is that it can bring a package of tangible and intangible assets (capital, technology, skills, management know-how, marketing capabilities, access to markets, etc.) to a host economy. While these assets are meant for use in a firm’s foreign affiliates to help maximize profits for the investing MNE as a whole, they also have a number of direct and indirect effects that can, under appropriate conditions, be of considerable benefit for a host country. For example, these assets can generate products for local consumption or for export, can lead to income and employment and can create backward and forward linkages and spillovers that strengthen the capabilities of domestic firms and human resources. In this manner, these tangible and intangible assets can contribute to local capacity-building, industrial and structural change, consumer welfare, higher labor and environmental standards, and improved living standards and poverty alleviation. 24 However, FDI can also have negative effects. MNEs can, for example, engage in restrictive business practices, abusive transfer pricing, the avoidance of taxes, and unfair competition; crowd out local firms; become a burden on the balance of payments; dominate industries central to economic growth and development; and jeopardize national security.

The task of policy makers is to maximize the positive effects of FDI and minimize the negative ones. Hence, national policies regarding FDI, and the international regulatory framework within which these policies are formulated, are of key importance to benefit as much as possible from the investment that host countries attract.

C. The importance of knowledge-intensive FDI

Among the intangible assets that host countries seek from FDI, none is perhaps more important than technology and innovative capacity. The reason is that technology is a key driver of economic growth and development, including because it affects the quantity, quality and variety of goods and services produced. This role of technology has become even more important as the pace of technological development accelerates. Moreover, technology involves not only knowledge that is codified as reflected in patents (and which are public), but also knowledge that is tacit and embodied in people (and which is typically private). Technology, broadly defined, also includes product and process technology (e.g., just-in-time production). The softer the technology, the more it is embodied in people. Tacit technology is particularly important in service industries, i.e., the single most important economic sector in most economies. Creating new product and process technology, wherever carried out, requires innovation and the innovative capacity established for that purpose.

Enterprises are at the core of technology transfer and innovation, operating typically within national systems of innovation. World spending on research and development (R&D) in 2012 was around US$1.4 trillion, with ten countries (including a number of developing countries) spending about four-fifths of the total; 25 if anything, the gap between these ten and the rest is widening. OECD members accounted for 60 percent of the world’s total R&D spending, down from 90 percent a decade earlier (a decline also reflected in the shrinking share of developed countries in the total number of the world’s patents, with China playing a particularly important role in this respect). This decline is partly a result of a meager growth of R&D expenditures by developed countries during 2008–2012 (at an annual rate of 1.6 percent) on the one hand, while expenditures of other countries grew at a faster rate, on the other. China’s R&D spending alone doubled during the same period, 26 and the country may well become the world’s top R&D spender by the end of this decade, given her strong commitment to science, technology and innovation development. (China’s R&D intensity is already on par with that of the European Union.) In absolute figures, the OECD countries spent a combined total of US$1.1 trillion on R&D in 2012, while the enlarged BRICs group (Brazil, Russia, India, China, plus Indonesia and South Africa) spent US$330 billion during the same year, in an effort to move toward higher value-added manufacturing.

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In most countries, some 10-20 percent of R&D spending is funded from public money, that is, the lion's share of R&D is undertaken by the enterprise sector. 27 And, among enterprises, MNEs are the principal generators and depositories of technology. Among the largest of them, R&D is concentrated in a few sectors, chiefly pharmaceuticals, biotechnology, technology hardware and equipment, and automobiles. These sectors alone account for about half of total R&D spending. Activities related to information and telecommunications technology, as well as healthcare, are among the most dynamic sectors. More specifically, dynamic R&D areas can be gleaned from what the OECD calls “patent bursts”. 28 These include climate change mitigation; ageing, health and food security; information and communication management; and new manufacturing processes. The convergence of a number of these technologies offers further possibilities for R&D.

Not surprisingly, host countries expect to benefit from this capacity and, hence, actively seek to foster technology transfer and the establishment of innovative capacity. And a number of countries have been successful in this effort. For example, foreign affiliates in Ireland accounted for some 71 percent of the country's business R&D in 2009, and that share was over 55 per cent in Austria, Belgium, the Czech Republic, Hungary, Israel, and the United Kingdom. 29 This can also be illustrated by anecdotal evidence. For example, China had managed to attract about 1,800 R&D facilities by the end of 2012. 30 The city of Shanghai alone has attracted 360 R&D centers, and even Africa is becoming a location for R&D facilities, as reflected, for instance, in IBM’s decision to open such an operation in Nairobi. 31 The pattern of R&D moving away from developed countries can also be illustrated by looking at one developed country, Japan:

[This] pattern is confirmed by the salient examples of Western MNCs which have closed their Japanese R&D facilities and relocated them from Japan to other parts of Asia, as represented by Pfizer (in 2008), Novartis (in 2008), Bayer Schering Pharma (in 2007), GlaxoSmithKline (in 2007), Merck (in 2006), among others, just to look at the typical examples among the pharmaceutical industry. Similar trends can be observed in other firms in different industries, such as Texas Instruments with its shifting focus on India (semiconductor industry), IBM Yamato Laboratory (PC industry), just to list a few. An even more surprising move can be seen for P&G which arguably has stuck with Japan as being the most significant country not only as its market but also as a major source of innovation (Bartlett, SKII case). Nevertheless, P&G seems to have shifted its strategic focus toward Singapore as an alternative locus of innovation and a strategic control center. While many such cases show relocations from Japan to other East Asian locations, increasing numbers of relocations are taking place beyond the East Asia, to Singapore and India as alternative locations. 32

27 See, Mariana Mazzucato, The Entrepreneurial State: Debunking Public vs. Private Sector Myths (London: Anthem Press, 2013), coming to the conclusion the entrepreneurial states (United States, United Kingdom, Germany) funding early R&D are the most innovative ones.
29 Ibid., p. 43.
While this anecdotal evidence illustrates a trend, systematic data for announced and opened R&D facilities (design, development and testing, research and development) show its overall magnitude (tables 2 and 3). Convincingly, 5,020 out of 9,104 of such facilities announced or established world-wide between 2003 and 2014 were created in Asia and the Pacific, Latin America and the Caribbean, the Middle East, and Africa -- 55 percent of the world total. Asia and the Pacific alone accounted for 82 percent of the facilities established in this group of countries, attracting the highest number of facilities of all regions in each year during the period 2003-2014. A similar picture emerges if one looks at the capital expenditures associated with these R&D facilities: out of the total of US$155 billion in estimated capital expenditures associated with the total number of R&D facilities established during the period 2003-2014 in Asia and the Pacific, Latin America and the Caribbean, the Middle East, and Africa, US$130 billion were spent in Asia and the Pacific, 84 per cent of the total in these regions – a substantial sum that testifies to the dynamism of that region. Except for one year, in each year during that period Asia and the Pacific chalked up the highest amount of estimated capital expenditures for R&D facilities among all the regions covered.

### TABLE 2: Announced and opened R&D centers, by region, 2003-2014 (Number of FDI projects)

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<tr>
<th>Region</th>
<th>2005</th>
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<th>2009</th>
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<th>2012</th>
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<td>Rest of Europe</td>
<td>03</td>
<td>03</td>
<td>03</td>
<td>04</td>
<td>00</td>
<td>02</td>
<td>00</td>
<td>03</td>
<td>00</td>
<td>00</td>
<td>114</td>
</tr>
<tr>
<td>Latin America &amp; Caribbean</td>
<td>20</td>
<td>24</td>
<td>19</td>
<td>31</td>
<td>33</td>
<td>40</td>
<td>49</td>
<td>61</td>
<td>73</td>
<td>83</td>
<td>903</td>
</tr>
<tr>
<td>Middle East</td>
<td>05</td>
<td>10</td>
<td>10</td>
<td>19</td>
<td>11</td>
<td>31</td>
<td>27</td>
<td>25</td>
<td>17</td>
<td>29</td>
<td>117</td>
</tr>
<tr>
<td>Africa</td>
<td>10</td>
<td>11</td>
<td>11</td>
<td>26</td>
<td>16</td>
<td>11</td>
<td>13</td>
<td>16</td>
<td>17</td>
<td>16</td>
<td>158</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>570</td>
<td>662</td>
<td>702</td>
<td>852</td>
<td>730</td>
<td>858</td>
<td>723</td>
<td>728</td>
<td>862</td>
<td>771</td>
<td>9104</td>
</tr>
</tbody>
</table>

Source: fDi Markets from the Financial Times Ltd.

### TABLE 3: Estimated capital expenditures for announced and opened R&D centers, by region, 2003-2014 (Millions of US dollars)

<table>
<thead>
<tr>
<th>Region</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asia-Pacific</td>
<td>9670</td>
<td>10563</td>
<td>11666</td>
<td>16623</td>
<td>17191</td>
<td>12702</td>
<td>12351</td>
<td>10618</td>
<td>10682</td>
<td>6694</td>
<td>7494</td>
<td>8682</td>
<td>129716</td>
</tr>
<tr>
<td>Western Europe</td>
<td>3163</td>
<td>3115</td>
<td>4220</td>
<td>7765</td>
<td>5499</td>
<td>5176</td>
<td>4303</td>
<td>4182</td>
<td>4220</td>
<td>3616</td>
<td>4069</td>
<td>4129</td>
<td>54269</td>
</tr>
<tr>
<td>North America</td>
<td>3459</td>
<td>1547</td>
<td>3235</td>
<td>1074</td>
<td>3303</td>
<td>3090</td>
<td>4569</td>
<td>3221</td>
<td>3876</td>
<td>4014</td>
<td>10104</td>
<td>5452</td>
<td>48333</td>
</tr>
<tr>
<td>Rest of Europe</td>
<td>700</td>
<td>916</td>
<td>500</td>
<td>997</td>
<td>900</td>
<td>916</td>
<td>2161</td>
<td>1477</td>
<td>1799</td>
<td>1627</td>
<td>1230</td>
<td>17906</td>
<td></td>
</tr>
<tr>
<td>Latin America &amp; Caribbean</td>
<td>381</td>
<td>708</td>
<td>2776</td>
<td>2044</td>
<td>666</td>
<td>1449</td>
<td>1329</td>
<td>1401</td>
<td>1881</td>
<td>820</td>
<td>1674</td>
<td>16663</td>
<td></td>
</tr>
<tr>
<td>Middle East</td>
<td>97</td>
<td>159</td>
<td>207</td>
<td>1077</td>
<td>495</td>
<td>644</td>
<td>594</td>
<td>747</td>
<td>422</td>
<td>151</td>
<td>211</td>
<td>7590</td>
<td></td>
</tr>
<tr>
<td>Africa</td>
<td>245</td>
<td>46</td>
<td>305</td>
<td>677</td>
<td>321</td>
<td>264</td>
<td>984</td>
<td>654</td>
<td>756</td>
<td>203</td>
<td>211</td>
<td>276563</td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>17760</td>
<td>21744</td>
<td>23098</td>
<td>31052</td>
<td>22919</td>
<td>25532</td>
<td>25067</td>
<td>21553</td>
<td>25706</td>
<td>19025</td>
<td>22680</td>
<td>22024</td>
<td>276563</td>
</tr>
</tbody>
</table>

Source: fDi Markets from the Financial Times Ltd.

33 Note that the data refer to "announced and opened" establishments, i.e., some facilities may not have been implemented or may have been implemented over time. Similarly, the data do not provide a breakdown in terms of the various types of facilities that are captured under the heading "R&D facility". The data do however allow comparisons over time.
The share of Asia and the Pacific has been around 50 percent during various time spans of the period 2003-2014, with China being not only by far the most attractive host country in that region but also the single most attractive host country for new establishments throughout the world (figure 4). Noticeable is also the substantial difference between Asia and the Pacific on the one hand, and the other regions on the other hand. Thus, Latin America and the Caribbean attracted between 3-10 percent of facilities between 2003 and 2013, Africa and the Middle East attracted between 2-4 percent of these facilities and the transition economies between 1-4 percent (figure 4). While the United States has maintained its share of 13 percent, that of Western Europe has declined from 29 to 22 percent of international R&D projects.

**FIGURE 4: Regional distribution of announced and opened R&D projects, based on number of projects, 2003-2007, 2008-2012, and 2013 (Percentages)**

In sum, emerging markets in general, and developing countries in particular, have become increasingly attractive to foreign investors, including by attracting knowledge-intensive activities. This is a result of their improving economic FDI determinants, their improved regulatory frameworks and their active efforts to attract such investment.

Going forward, emerging markets need to remain aware that their efforts are taking place in a highly competitive world FDI market and in the framework of increasingly integrated international production networks that have made FDI more important than trade in terms of bringing goods and services to foreign markets: the sales of foreign affiliates are considerably higher than world exports (table 4). This, in turn, has policy implications, some of which will be discussed later in this report.

**TABLE 4: Selected indicators of FDI and international production, 2013 and selected years**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Value added at current prices (Billions of US dollars)</td>
<td>208</td>
<td>1,492</td>
<td>1,700</td>
<td>1,320</td>
<td>1,482</td>
<td></td>
</tr>
<tr>
<td>FDI inflows</td>
<td>341</td>
<td>1,832</td>
<td>1,712</td>
<td>1,347</td>
<td>1,417</td>
<td></td>
</tr>
<tr>
<td>FDI outflows</td>
<td>2,676</td>
<td>14,790</td>
<td>21,917</td>
<td>23,304</td>
<td>28,464</td>
<td></td>
</tr>
<tr>
<td>FDI inflows and FDI outflows</td>
<td>5,056</td>
<td>18,894</td>
<td>21,913</td>
<td>23,916</td>
<td>28,516</td>
<td></td>
</tr>
<tr>
<td>FDI inflows and FDI outflows</td>
<td>79</td>
<td>1,072</td>
<td>1,693</td>
<td>1,581</td>
<td>1,746</td>
<td></td>
</tr>
<tr>
<td>Rate of return on inward FDI *</td>
<td>3.5</td>
<td>7.3</td>
<td>6.9</td>
<td>7.6</td>
<td>6.6</td>
<td></td>
</tr>
<tr>
<td>Rate of return on outward FDI *</td>
<td>155</td>
<td>1,139</td>
<td>1,500</td>
<td>1,559</td>
<td>1,626</td>
<td></td>
</tr>
<tr>
<td>Rate of return on outward FDI *</td>
<td>6.0</td>
<td>7.2</td>
<td>6.8</td>
<td>7.2</td>
<td>6.9</td>
<td></td>
</tr>
<tr>
<td>Gross fixed investment in US dollars</td>
<td>111</td>
<td>760</td>
<td>2,084</td>
<td>994</td>
<td>1,400</td>
<td></td>
</tr>
<tr>
<td>Sales of foreign affiliates</td>
<td>4723</td>
<td>21,489</td>
<td>28,516</td>
<td>31,555</td>
<td>34,698</td>
<td></td>
</tr>
<tr>
<td>Value added by domestic or foreign affiliates</td>
<td>681</td>
<td>4,875</td>
<td>6,260</td>
<td>7,089</td>
<td>7,492</td>
<td></td>
</tr>
<tr>
<td>Total value of foreign affiliates</td>
<td>5,895</td>
<td>40,179</td>
<td>53,784</td>
<td>51,905</td>
<td>58,245</td>
<td></td>
</tr>
<tr>
<td>Value added by foreign affiliates</td>
<td>4,956</td>
<td>35,514</td>
<td>46,520</td>
<td>41,522</td>
<td>47,721</td>
<td></td>
</tr>
<tr>
<td>Employment of foreign affiliates (thousands)</td>
<td>20.635</td>
<td>33,316</td>
<td>43,416</td>
<td>47,156</td>
<td>57,730</td>
<td></td>
</tr>
</tbody>
</table>

THE RISE OF EMERGING MARKET MNEs
CHAPTER 2. THE RISE OF EMERGING MARKET MNEs

The year 2013 was another banner year for outward FDI from emerging markets, further increasing their share in world FDI flows (figure 5). The rise of emerging market MNEs is indeed impressive. More than half of all emerging markets reported FDI outflows during the past five years, and there are now more than 30,000 MNEs headquartered in these countries. FDI outflows from these economies averaged about 2 percent of a rough annual average of US$50 billion world FDI outflows during 1980-1985, compared to 39 percent of US$1.4 trillion world FDI outflows during 2013. In absolute amounts, FDI outflows from emerging markets had risen from about US$1 billion during 1980-1985, to US$560 billion in 2013 (US$460 billion from developing countries and US$100 billion from transition economies) – the latter figure being more than ten times world outflows three decades ago. Since 2004, outward FDI flows from emerging markets have been over US$100 billion annually; in 2013, six of the top 20 home countries were emerging markets (figure 2). MNEs from these countries have become important players in the world FDI market.

As in the case of MNEs headquartered in developed countries, emerging market MNEs use M&As as an important mode of entry into foreign markets. The important role of emerging market MNEs is reflected in the fact that, in 2013, these firms accounted for 56 percent of cross-border acquisitions world-wide. Moreover, some two-thirds of these M&As involved targets in other emerging markets, including a substantial number of foreign affiliates originally controlled by MNEs headquartered in developed countries. These transactions increasingly involve targets in developed countries and in all industries.

FIGURE 5: Share of FDI outflows by group of economies, 1999-2013 (Percentages)


34 Data for 2014 were not available at the time of writing of this report.
38 Ibid., p. 7.
One distinctive characteristic of outward FDI from emerging markets is the role that state-controlled entities, especially state-owned enterprises (SOEs), but also sovereign wealth funds, play in these transactions in a number of countries (notably in the case of China, but also in the cases of Russia, Singapore and a number of Arab states). But this statement needs to be qualified in at least two respects. First, the outward FDI stock (as opposed to other investment) of sovereign wealth funds has been minimal so far, amounting probably to not more than US$150 billion (compared to a world FDI stock of US$26 trillion) in 2013. 39

Second, while outward FDI by emerging market SOEs is rising, it is not as large as that of SOEs based in developed countries. More specifically, 40 49 of the 200 largest non-financial MNEs 41 were SOEs in 2010. The foreign assets of these 49 together accounted for US$1.8 trillion. Of these 49 SOEs, 20 SOEs were headquartered in developed countries and 29 in emerging markets, with foreign assets of US$1.4 trillion and US$0.4 trillion, respectively. These SOEs operate in a wide range of sectors. In other words, SOEs are among leading players in the world FDI market and they are more numerous among the leading MNEs headquartered in emerging markets; but the foreign assets of those headquartered in developed countries are considerably higher than those of the largest SOEs headquartered in emerging markets. Still, as discussed below, the role of state-controlled entities in the outward FDI of emerging markets has led to policy initiatives aimed at addressing this role.

Among emerging markets, China is the star performer. The country’s FDI outflows amounted to US$101 billion in 2013 and an estimated US$116 billion in 2014, 42 located in 156 economies and undertaken by 6,128 MNEs. 43 This compares to only US$3 billion annually on average during 2000-2003. The salient features of China’s outward FDI are that they predominantly come from three major economic centers (the Yangtze River Delta, the Pearl River Delta, the Bohai Gulf); that the Asian neighborhood (mostly Hong Kong) is the primary first host region of the country’s outward FDI; that developed countries and services as well as natural resources are the major destinations; and that (as already mentioned) SOEs, particularly the 115 central ones, are the dominant players, with M&As becoming a fast rising mode of entry.

China’s FDI outflows are now far higher than those of all other emerging markets, including (in 2013) those of its BRICs partners, Brazil (- US$3.5 billion), Russia (US$95 billion) and India (US$1.7 billion). As of the year-end of 2013, China’s OFDI stock had reached US$614 billion, more than twenty times that in 2000 (US$28 billion). Not surprisingly, therefore, the share of China’s outward FDI flows in the outflows of all emerging markets has grown dramatically, from a single digit average annual share of 4 percent during 2000-2003 to 18 percent in 2013. Globally, however, China remains a small player, with only a share of less than 7 percent of the world’s total outward FDI flows in 2013. Similarly, China’s OFDI stock at the end of 2013 was only one-tenth of that of the United States and one-third of that of the United Kingdom, and lower than that of such small European countries as Belgium and Switzerland.

39 In 2013, the cumulative stock of FDI from sovereign wealth funds had reached US$130 billion; see, UNCTAD, 2014, p. 19.
41 This compares to only US$3 billion annually on average during 2000-2003. The salient features of China’s outward FDI are that they predominantly come from three major economic centers (the Yangtze River Delta, the Pearl River Delta, the Bohai Gulf); that the Asian neighborhood (mostly Hong Kong) is the primary first host region of the country’s outward FDI; that developed countries and services as well as natural resources are the major destinations; and that (as already mentioned) SOEs, particularly the 115 central ones, are the dominant players, with M&As becoming a fast rising mode of entry.
42 The 2014 amount had to be estimated as, at the time of the writing of this report, China’s FDI outflows in the financial sector had not yet been published. Outflows in the non-financial sector in 2014 were US$103 billion (see, http://fec.mofcom.gov.cn/article/tjzl/jwzt/ jwzt/201501/1853462_1.html). During 2011-2013, outflows in the financial sector averaged 13 percent of those of the non-financial sector (see, Statistical Bulletin of China’s Outward Foreign Direct Investment, 2011-2013). This ratio was applied to the 2014 non-financial sector outflows, to arrive at the estimated total of China’s outward FDI flows in 2014.
Remarkably, China’s FDI outflows may well surpass the country’s inflows in 2015 or 2016, having reached US$116 billion and US$128 billion, respectively, in 2014 (figure 6). The drivers of this growth – the need to secure natural resources, acquire created assets (of particular interest to a number of emerging market firms), seek markets, improve efficiency, and special factors (such as escape FDI) – are all likely to continue to operate, and they are quite similar to the motives of firms based in other emerging markets (and, for that matter, firms based in developed countries) to invest abroad. In the end, it is the quest to improve their international competitiveness that lead firms to expand abroad through FDI, to obtain better access to markets and resources of all kinds. In the case of a number of emerging markets (and particularly China), this is underpinned by rapid economic growth (which strengthens the capacity of firms to undertake investment and increases the need for inputs), rising exports (which encourages trade-supporting outward FDI of all kinds), the possibility of trade restrictions regarding exports (which would make becoming an “insider” in foreign markets through FDI advisable), a helpful outward FDI regulatory framework, and, in the case of China, an appreciating renminbi (which makes production in China less competitive, but also makes outward FDI cheaper), and rising production costs (which encourages the shift of labor intensive production abroad).

44 A substantial share of China’s outward FDI goes to tax havens and/or financial centers, perhaps as much as four-fifths. (The same is true for a number of other emerging markets, e.g., Brazil and Russia.) These flows represent, in most cases, not productive investment, but rather transactions undertaken for such reasons as roundtripping, transshipment or to benefit from lower taxes or to avoid taxes altogether. For this reason, it is virtually impossible to obtain an accurate picture of the sectoral and geographic distribution of the outward FDI of the countries involved, as it is not known where investments are ultimately made.


FIGURE 6: FDI inflows and outflows, China, 1990-2014 ( billions of dollars)
One of these factors deserves special attention, namely the presence of a helpful outward FDI framework, exemplified by China. Indeed, China is one of the few developing countries that has an elaborate policy and regulatory framework dealing with outward FDI. It is a framework that has moved over time from restricting, to facilitating, to supporting, to encouraging outward FDI; still, it has strong elements of administrative control that make it cumbersome. The framework serves two objectives: to help Chinese firms become more competitive internationally and to assist the country in its development effort. However, since SOEs seem to benefit particularly from the current framework when internationalizing, this policy approach has raised concern in a number of developed countries, as will be discussed below.

Furthermore, the rapid rise of China’s outward FDI – and, for that matter, the rise of outward FDI from emerging markets in general -- draws attention to a number of constraints that these investments face. In particular, the changing climate for FDI in general and the rise of FDI protectionism may stymie the outward expansion of Chinese and other firms headquartered in emerging markets. In a number of developed countries, Chinese FDI – as well as that of a number of Arab countries and Russia -- is regarded with suspicion (even though it typically accounts for a very small share of all inward FDI), especially because the bulk of it is made by state-controlled entities; there is also the possibility of a backlash against Chinese investment in developing countries. In the case of state-controlled entities, there are concerns that these entities may receive benefits from their governments that put them into a competitive advantage vis-à-vis their private counterparts when investing abroad. Not surprisingly, therefore, regulatory attention has begun to focus on FDI by state-controlled entities. This is reflected in the strengthening or creation of review mechanisms for inbound FDI in a number of countries, led by the United States. For example, the Foreign Investment and National Security Act of the United States establishes the presumption that an investigation needs to be undertaken by the Committee on Foreign Investment in the United States if an M&A in the United States is undertaken by a foreign state-controlled entity.

But there are also other challenges that outward investors from emerging markets face, some of these being the result of most emerging market MNEs being “young”, i.e., they have not been MNEs for a long time and therefore lack experience in operating in foreign markets through FDI. These include difficulties in finding a local partner, local consumers being unfamiliar with brands of emerging market MNEs, a lack of international management capacity, difficult access to financial resources, cultural dissimilarities, and lack of understanding of host countries’ regulations. Some of these (and other) challenges will require the attention of the governments of emerging markets, as well as emerging market MNEs themselves. But they will also require a dispassionate look by host countries at FDI from emerging markets to make sure that any risks associated with FDI from these countries are minimized (risks that often are also associated with any other FDI) and benefits are maximized. This issue will be addressed briefly in the concluding section.

CHAPTER 3

INVESTMENT POLICIES
CHAPTER 3. INVESTMENT POLICIES

The rise of an integrated international production system and the global value chains associated with it was possible because of an enabling policy framework, both at the national and international levels. The hallmarks of this framework are that countries not only allow FDI to take place, but in fact actively seek to attract it, and that they protect it through international investment agreements (IIAs), especially bilateral investment treaties (BITs).

A. The national level

(i) Inward FDI policies

The defining characteristic of national FDI policies has been to make the investment climate more welcoming for foreign investors. Concretely, some 95 percent of all FDI policy changes around the world during the 1990s involved the liberalization of national investment regimes or otherwise facilitating inward FDI. This reflects the desire of all countries to attract FDI in order to help them advance their economic growth and development. Typically, governments have reduced entry barriers (especially by opening up sectors to foreign investors), facilitated the operations of such investors in their countries and offered various kinds of incentives.

The establishment of investment promotion agencies (IPAs), whose principal purpose was – and remains – to attract FDI, further complemented such policy measures. As mentioned earlier, there are at least 10,000 agencies world-wide whose terms of reference are, or include, to attract investment. Virtually every country in the world has established a national IPA (and, not surprisingly, they vary greatly in their capacity). As this figure implies, many more exist at the sub-national or even city levels. The implication is that there is strong competition among IPAs for foreign investors.

The nature of this competition has evolved over time. In what could be called a first generation of investment promotion, countries simply opened up to FDI, typically by liberalizing their FDI regimes. In a second generation, countries began to engage in active promotion of a general nature, for instance, by signaling to investors (e.g., through advertising in newspapers) that they are open for FDI; a number of IPAs are still at that stage. In a third generation, a rising number of IPAs have moved toward targeting foreign investors in light of their development priorities or other considerations (e.g., to diversify their sources of FDI). Such targeting involves a more judicious utilization of typically scarce resources; but it also entails the risk of wrong sectors being targeted, if it is not done on the basis of a careful analysis of the strengths, weaknesses, opportunities, and threats of the given location to determine the country’s comparative advantages.

One area that a number of developing countries are targeting concerns transfer of technology and the establishment of innovative capacities, especially R&D facilities. As has been documented earlier, developing countries have been successful in this respect. The opportunities for attracting such FDI are improving, for a number of reasons, as well as various push and pull factors. One of the reasons concerns the evolution of MNEs into integrated international production networks and the global value chains that are part of them: in such a context, it is less possible for firms to use advanced technology in one part of their systems (e.g., their home countries), and less sophisticated technology in another part of their systems (e.g., their host – developing - countries), precisely because of the integrated nature of these productions systems and their global value chains. Rather, MNEs need to apply state-of-the-art technology throughout their corporate systems, especially if their production is destined for the demanding markets of the developed countries, either through assembly or exports. As a result – and to the extent that developing countries can attract such investment - they are in a good position to encourage transfer of technology to the foreign affiliates located in their territories.

52 See, UNCTAD, World Investment Report, various editions.
53 Millennium Cities Initiative, op. cit.
In the case of R&D facilities, host countries are helped in their efforts to attract such facilities by various push and pull factors. R&D facilities are traditionally very “sticky”, that is, they are typically located in home countries, often in research triangles, near universities, and close to crucial production operations. However, R&D activities are increasingly subject to the same pressures as manufacturing and other services: they need to locate where they can be done best from the perspective of the corporate systems as a whole. The push factors include the competitive pressure to innovate more and more and faster and faster, while keeping costs in check. Raising wages for R&D personnel, combined with bottlenecks in certain areas, encourages firms to look outside their traditional R&D bases, the developed countries, and to tap into knowledge centers elsewhere. Pull factors include improved national systems of innovation in developing countries and their widening skills base at considerably lower costs. Moreover, creating integrated global R&D networks permit a continuous process of innovation: through use of shared databases, R&D specialists can work on-line in one country and pass on their work at the end of the day to their colleagues in other time-zones.

However, the challenge does not stop with encouraging technology transfer to foreign affiliates located in host countries or attracting R&D facilities. Host countries have an interest in encouraging foreign affiliates to disseminate the technology that is being transferred to them to domestic firms, to assist the latter in their upgrading to world-market standards. There are a number of ways in which this can be done. These include the conclusion of joint ventures, spillovers, demonstration effects, and employee turnover. But the best manner in which this can be done is through the backward and forward linkages of foreign affiliates. 55

Backward linkages (i.e., local sourcing) are particularly important. They are in the mutual interest of both host countries and foreign investors. Host countries benefit from them because linkages are the single most important channel through which technology (and other assets, such as business experience and management practices) can be transferred to local enterprises, upgrading these in turn to world standards and, in the end, helping host developing countries in their economic development. (They also embed foreign affiliates more firmly in their host countries’ economies.) MNEs benefit from such linkages – assuming (and this is a critical assumption) that price and quality are competitive – because they may be able to obtain local inputs at a lower price (without compromising on quality) and, importantly, reduce the risk of supply-chain disruption.

Considerations related to the latter factor are becoming more important as outsourcing becomes more common, just-in-time production is adopted by more MNEs and global value chains become longer and more specialized, with one implication being that disruptions are more likely to occur. Such disruptions can occur for various reasons (figure 7). They include natural disasters, such as the 2011 floods in Thailand and the 2011 earthquake and tsunami in Japan; in both cases, international supply chains involving both countries were severely disrupted, at significant costs for the firms involved. 56

In the case of the disaster that befell Japan, it was estimated that one-third of the daily global automotive production was immediately implied for production in other countries.

But disruptions can also occur on account of political risk – and political risk was ranked second by firms among the factors constituting a constraint on investing in developing countries (figure 8). 58 These risks can include (as identified in a survey of investors in 2013), in order of importance, adverse regulatory changes, breach of contract, transfer and convertibility restrictions, civil disturbances, non-honoring of financial obligations, expropriation, terrorism, and war. 59 Moreover, precisely because of outsourcing, just-in-time production and global value chains, political risks event in one country can have immediate implications for production in other countries.


57 See, Justin Rohrlich, “Effects of Japan disaster on global supply chain still unknown”, Minyanville, March 29, 2011.

58 See, MIGA, World Investment and Political Risk (Washington: MIGA, various years).

The incipient trend toward “in-shoring” is partly fueled by the desire of firms to shorten supply chains. From the point of view of host countries, therefore, these considerations create opportunities to build linkages with foreign affiliates and, in this manner, benefit from the technology that these affiliates utilize.

For an extensive discussion of what governments can do to foster linkages, see, UNCTAD, 2001, op. cit.

 Forgiving such linkages requires that there is domestic capacity (in particular suppliers), i.e., firms that are “linkage-ready” in that they are able to deliver at a quality and price that is internationally competitive – a challenge in many developing countries. While MNEs may undertake their own efforts to help local firms to become linkage-ready (especially if they have a strong self-interest to source supplies locally) through their supplier development programs, the governments of interested host countries may need to help where this is not the case. Recognizing this challenge, and acknowledging the importance of linkages, a number of developed and developing countries have instituted linkages programs through which they help, on the one hand, domestic firms to get ready to link up with foreign affiliates and, on the other, encourage foreign affiliates to build such linkages with domestic firms.  

60 For an extensive discussion of what governments can do to foster linkages, see, UNCTAD, 2001, op. cit.
The single most important bottleneck in this respect is often insufficient technological and managerial capacity, combined with inadequate quality standards. At the same time, these same factors determine to a large extent the ability of host economies to absorb and benefit from the knowledge that technology linkages can entail. The governments of host countries can proactively help overcome the underlying capability and information gaps. Concrete measures include providing information; matchmaking between domestic firms and foreign affiliates; encouraging foreign affiliates to participate in programs that seek to upgrade the technological capabilities and quality standards of domestic suppliers, including through technological alliances between domestic firms and foreign affiliates; promoting the establishment of supplier associations and business clinics; providing various services, especially through training; encouraging foreign affiliates to obtain product mandates from their parent firms; helping domestic suppliers to obtain access to finance needed to upgrade their capabilities; offering focused incentives to upgrade technology; and establishing industrial parks and technology clusters. 61

**FIGURE 8: Most important constraints to FDI in developing economies (Percentages)**

![Figure 8: Most important constraints to FDI in developing economies (Percentages)](image)


Finally, and this is particularly important for countries seeking to encourage the dissemination of technology through linkage programs or otherwise, the regulatory environment needs to be such that MNEs do not fear to transfer technology to their foreign affiliates (and through them, to local suppliers) on account of possibilities of technology leakage to unauthorized other firms. The adequate protection of intellectual property is therefore important. At the same time, such protection may be less important in some sectors (especially for many services, standardized manufacturing, natural resources) than in others (e.g., pharmaceuticals, software). Still, this is a policy aspect that host country governments need to consider carefully, and that will be discussed further in the concluding chapter.

61 See, ibid.
While encouraging the transfer of technology and its dissemination is important as a means to advance their economic growth and development, it is the building up of innovative capacity that is key in the longer run. Attracting R&D facilities is one way to accelerate this process. The protection of intellectual property is relevant here as well (if not even more so), of course, but so is the nurturing of domestic capacity. This can be done through, for example, encouraging link-ups with domestic universities and the creation of technology parks. Again, this is not an easy endeavor. To be successful requires a careful assessment of local capacities and government intervention to create the necessary incentives for MNEs to match their own requirements with local capabilities. The fact that R&D personnel in developing countries – and especially in such countries as China and India – is becoming more plentiful and is available at costs considerably lower than in developed countries, is very helpful in this respect. Countries that fulfill these pre-conditions are in a favorable position to attract R&D facilities. Focusing on targeting such facilities is increasingly an option – and opportunity – for a growing number of developing countries.

It needs to be recognized, though, that the competition among IPAs to attract FDI in general and technology-intensive projects in particular, has become more sophisticated, for instance, by paying more attention to policy advocacy and focusing more on after-investment services to court investors that are already established in the country. IPAs have come to realize that satisfied foreign investors are a country's best "ambassadors" to help attract other investors. As the national FDI regulatory frameworks become similar across the world, investment promotion gains in importance.

In recent years, however, national policies toward FDI have become more nuanced, reflected in the increasing share of national policy measures that make the investment climate less welcoming (figure 9). Partly, this is a result of the reaction of countries to the rise of FDI from emerging markets (discussed earlier). This development has made developed countries more aware that they are not only the principal home countries but also have been the principal host countries – and now are becoming important host countries for non-traditional investors as well, including investors headquartered in countries that have different economic systems, may have a critical attitude toward developed countries in general (or some of these countries in particular) and may even be strategic competitors. When firms headquartered in such countries engage in incoming M&As – especially if these take place in sensitive industries or are undertaken by state-controlled entities – this may create concerns, in the public and in governments, for the reasons discussed earlier (and to be discussed further in the concluding section).

National FDI policies have also become more nuanced on account of the evaluation by governments that greenfield investments are more desirable than M&As. From the perspective of firms, M&As are often the preferred mode of entry into foreign markets as they allow the acquiring firms to establish themselves quickly, acquire market share and benefit from the established networks (including suppliers and sales agents), brand names and technological capacity of the targets. For host countries, the cost/benefit calculation is different. In particular, M&As often are associated with the closing of production lines (including R&D facilities) and lay-offs. Most importantly, they do not create new production capacity – an objective of particular importance for developing countries. Hence, M&As are sometimes regarded with suspicion. This is one of the reasons for the strengthening of review mechanisms for incoming FDI. While red tape has not replaced red carpet for incoming FDI, governments are taking a more differentiated approach toward such investment.

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62. Reinvested earnings account for a substantial share of world FDI flows: a record level of 67 percent of FDI flows from developed countries were composed of reinvested earnings in 2013; see, UNCTAD, 2014, op. cit., p. 5.

63. According to one study, every US$1 spent on investment promotion leads (with some qualifications) to US$189 in additional FDI inflows in the case of developing countries; see Torfinn Harding and Beata Smarzynska Javorcik, “Roll out the red carpet and they will come: investment promotion and FDI inflows”, Working Paper, Department of Economics, University of Warwick, Coventry, June 2010, available at: http://wrap.warwick.ac.uk/57330; and Torfinn Harding and Beata Smarzynska Javorcik, “Roll out the red carpet and they will come: Investment promotion and FDI inflows”, Columbia FDI Perspectives, no. 72 (2012).
More broadly, government expectations concerning inward FDI are changing. After all, for them such investment is – to repeat -- just a tool to contribute to the economic growth and development of their countries. This influences not only their attitude toward the benefit of M&As, but governments are now beginning actively to encourage more sustainable FDI, that is, investment that makes a maximum contribution to the economic, social and environmental development of host countries and takes place within mutually beneficial governance mechanisms while being commercially viable – sustainable FDI for sustainable development. In the end, this may give rise to a fourth generation of investment promotion strategies, that is, efforts to attract sustainable FDI. 64 In other words, governments are increasingly concerned with the quality of investment, not simply its quantity. Related to that, governments are paying more attention to competing objectives, especially national interests, essential security, the promotion of national champions, and the protection of certain national industries.

![FIGURE 9: Changes in national investment policies, 2000-2014 (Percentages)](image)


64 By the same token, more investors recognize the need to undertake investments that respond to the sustainable development needs of host countries and hence incorporate such considerations into the implementation of their investments - not simply as corporate social responsibility add-ons, but as core strategies and practices.
(ii) Outward FDI policies

The discussion so far has focused on inward FDI policies only. Another policy area that is increasingly attracting attention concerns outward FDI policies and, more specifically, policies to help one’s own firms invest abroad through various home country measures. These measures are typically intended to advance a home country’s strategic economic interests and, in particular, enhance the international competitiveness of its firms by helping them establish a portfolio of locational assets. Governments of developed countries have since long put in place such policies and the instruments that go with them (table 5), but only a few developing countries have followed suit so far. This raises the question of whether developing countries that do not have such policies in place are putting their own MNEs into a competitive disadvantage. This is the new frontier of national FDI policy making.

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Source: Sauvant, Economou, Gal, Lim, and Wilinski, op. cit., p. 16., a/ May include some financial support.

Home country measures involve the granting of specific advantages by a home country government (or one or more of its public institutions) in connection with the establishment, acquisition or expansion of an investment by a home country firm in a foreign economy. They span a wide spectrum of measures and are provided by a range of institutions (table 6).
### TABLE 6: Illustrative inventory of home country measures and outward FDI institutions

#### Institutional framework

1. Governmental departments/ministries, e.g.,
   a. Ministries of foreign affairs
   b. Ministries of commerce/trade/business
   c. Ministries of industry/economy/competitiveness
2. Export credit agencies
   a. Export-import banks
   b. Trade/investment insurers
3. Development finance institutions
4. Investment/trade promotion agencies
   a. Central offices on the national level
   b. Foreign offices set up abroad to help investors located in host countries
5. Local trade/investment promotion agencies
6. Private organizations fulfilling governmental mandates

#### Information and other support services

1. Information support
   a. Data on the economic and investment climate, legal environment, political situation in the host countries, business opportunities in particular economic sectors, etc.
   b. Information and data on outward investment, e.g.,
      i. Publications on the benefits of internationalization, legal and economic aspects of international expansion, etc.
      ii. Statistics
         c. Information on existing HCMs and services available for outward investors
2. Investment missions
3. Match-making services
   d. Organization of contacts with government officials and entrepreneurs in host countries
   e. Maintaining business matchmaking databases
4. Educational services
   f. Seminars, webinars and conferences on OFDI-related topics

**Financial measures**

1. Grants
   a. Feasibility studies, market research and other pre-investment activities
   b. Costs of setting up overseas offices
   i. Rent
   ii. Employee salaries
   c. Training and human capital development
      i. Training staff for employment in a foreign affiliate (e.g., immersion program, foreign language classes)
      ii. International human resources strategy and related third-party consultancy fees
      iii. Executive programs for managers
      iv. Internships
   v. Customized training programs

2. Loans
   a. Concessional loans
   b. Non-concessional loans
   c. Structured financing options
   d. Currency options
   e. Syndication, public-private/public-public risk-sharing arrangements
   f. Development financing

3. Financial guarantees

4. Equity participation
   a. Direct equity financing
   b. Quasi-equity financing
   c. Development financing

**Fiscal measures**

1. Tax exemptions
   a. Exemption from corporate income tax on certain incomes
Chapter 3. Investment policies

i. Tax exemption of foreign spin-offs’ income

ii. Tax exemption of start-up expenses of foreign operations
   b. Tax deductions for qualifying expenditures

2. Corporate tax rate relief
   a. Corporate tax rate relief for enterprises in particular sectors of economy

3. Tax deferral for qualifying income earned overseas

4. Tax credits for certain credits of expenditures
   a. Interest expenses allocation

5. Allowances for qualifying activities

**Investment insurance measures**

1. Investment insurance
   a. Range of investment insurance products/coverages
   b. Expropriation
   c. War damage
   d. Political violence
   e. to convert local currency or transfer currency out of the host country
   f. Suspension of remittance
   g. Forced abandonment

**Treaties**

1. Bilateral investment treaties

2. Other international investment agreements

3. Double taxation treaties

Thus, governments provide information services on, for example, the economic and legal investment climate in host countries, their political environment and business opportunities there. They may offer advice and consulting services and organize investment missions, match-making events and training and educational services related to outward FDI. Home country measures can also involve concrete financial measures, such as grants for feasibility studies, other pre-investment work, deferring costs of setting up foreign offices, training staff for employment in such offices, and executive training programs for managers. Financial assistance can also include loans, structured financing options, public-private/public-public risk-sharing arrangements, development financing, and equity participation (direct or as development financing). Furthermore, some home country governments have introduced certain fiscal measures to help their foreign investors. These can include tax exemptions of various kinds, deductions for certain expenditures (e.g., R&D), tax deferrals on incomes earned overseas and tax credits for certain kinds of expenditure, as well as corporate tax relief. Common is also the provision of political risk insurance. Such insurance can cover expropriation, war damage, political violence, the conversion of local currency (or its transfer out of the host country), the suspension of remittances, and the forced abandonment of assets. Each of these types of assistance helps investors establish themselves abroad and, therefore, provides them with an advantage over investors from countries whose governments do not provide such support.

Many countries have eligibility criteria to qualify for home country measures. Particularly popular is special support for small and medium-sized companies as these enterprises typically have difficulties venturing into foreign markets. Sectors in which investments are being made (with natural resources being an example, perhaps combined with a requirement to send these back to the home country) can come into play, as well as the destination of an investment (e.g., whether it is in a developing country), type of activity (e.g., whether it is technology-oriented), and effects of an investment on home/host countries (e.g., in terms of employment, technology transfer, impact on the environment).

The obvious question for governments of developing countries whose firms invest abroad (or are beginning to invest abroad) is whether they, too, should provide any type of support to their foreign investors and, if so, what kind of support it should be.

In considering this question, they need to weigh various considerations. On the one hand, there are such macro-economic considerations as the need to build productive capacity at home (together with the employment that comes with it), balance-of-payments implications and possible opposition, in particular from trade unions, to outward FDI (as such investment is often seen as transferring jobs abroad). On the other hand, there are micro-economic considerations pertaining in particular to the competitiveness of domestic firms: in a world in which competition is everywhere – through inward FDI, various non-equity forms (licensing, management contracts, subcontracting, etc.) – not allowing one’s own firms to invest abroad and providing some help to them in this respect handicaps these firms and puts them at a competitive disadvantage vis-à-vis other firms that are not only allowed to invest abroad but are actually helped by their governments in doing so. Weighing these macro- and micro-economic effects and the policy issues surrounding them against each other is not an easy thing to do and, most likely, requires a careful and phased approach. But as more and more firms from more and more developing countries invest abroad, the governments of these countries need to, sooner or later, turn their attention to this new frontier of national FDI policy making – an issue taken up again in the concluding chapter.

B. The international level

Developments at the national level, not surprisingly, are reflected at the international level in the evolution of the international investment law and policy regime. This regime, often neglected by national policy makers, is becoming increasingly important as it provides the parameters for national FDI policy making. Moreover, the international investment regime has “teeth”, as it provides investors direct access to an international dispute-settlement mechanism that allows them to seek redress in case they feel their rights have been violated by host countries, with awards against governments potentially being very high (not counting the costs of litigation).

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66 It should be noted that such opposition has arisen, from time to time, in developed countries, most recently in Western Europe (and particularly France) in the context of a discussion of “delocalisation”.

67 For example, countries could begin with providing information services.
When decolonization began to gather speed during the mid-twentieth century, combined with international criticism of MNEs at that time, developed countries - whose firms (as documented earlier) were at that time overwhelmingly the most important outward investors - began to worry about protecting the investment of their firms abroad in developing countries. This was all the more important as the international investment regime was, at that time, still in a very rudimentary stage: “foreign investors who sought the protection of international investment law encountered an ephemeral structure consisting largely of scattered treaty provisions, a few questionable customs, and contested general principles of law.” Furthermore, the international investment regime was challenged in important respects (in particular concerning issues involving nationalization and the applicability of international law) by developing countries.

In response, developed countries began to conclude bilateral investment treaties (BITs) and, later, other international agreements dealing in a substantive manner with international investment issues (collectively “international investment agreements” (IIAs)), whose principal purpose was to protect the investment of their firms in developing countries (whose judicial systems were not seen to be reliable). These treaties provided (and continue to provide) for a series of broadly formulated protections for foreign investors, including national treatment, most-favored-nation treatment, fair and equitable treatment, provisions for compensation in case of nationalization, and the repatriation of earnings. Moreover, they typically contain broad definitions of “investment” (basically everything that has a value for foreign investors) and “investors”. And, increasingly, they provided for investor-state dispute settlement. This dispute-settlement provision subsequently became very important as it gives firms a private right of action, namely, to bring claims directly against host country governments if they consider that any of their protections contained in an applicable BIT or other IIA were infringed upon. In other words, firms are not dependent, as in the case of the World Trade Organization, on their governments bringing a case against a country. De facto, therefore, and depending on the applicable IIAs, the great number of MNEs and their foreign affiliates, and even individual shareholders in these, have the power to enforce the international investment law and policy regime.

From a developing country perspective, IIAs were seen as desirable as the promise to protect foreign investment was expected to help attract much-needed FDI – it was a “grand bargain” of protection in exchange for more investment.

Not surprisingly, international investment treaties proliferated. While the first BIT was concluded in 1959, their number had reached 371 by the end of the 1980s. Their number virtually exploded during the 1990s, the heyday of FDI liberalization (see also the data cited earlier on national FDI policy changes), to reach 1,862 by the end of the 1990s. By the end of 2014, that figure stood at 2,923 BITs and 345 other IIAs. Moreover, the scope of these treaties has gradually expanded to include various liberalizing provisions, particularly national treatment at the pre-establishment phase of an investment. Together, these agreements provide powerful protection to foreign investors, even if they do not amount to a multilateral framework on investment. If the current negotiations on various mega-regional free trade agreements (all of which most likely will include investment chapters) should be concluded successfully, the international investment regime would be further strengthened. Particularly important here are the Trans-Pacific Partnership agreement, the Transatlantic Trade and Investment Partnership, and the Regional Comprehensive Economic Partnership Agreement in Asia.

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69 Through an “umbrella clause”, treaty protection can be extended to contracts that foreign investors have with host country institutions, thus widening the reach of a treaty.
70 See the title of the article by Salacuse and Sullivan, op. cit.
71 Between Germany and Pakistan.
72 Only BITs still in effect in 2013. Courtesy UNCTAD Secretariat.
73 Ibid.
74 UNCTAD, IIA Issues Note, no. 1, February 2015.
As a result, the “ephemeral structure” of international investment law of the 1960s and 1970s has given way to a strong international investment law and policy regime at the beginning of the 21st century:

*Investment treaties … have built, indubitably, one of the most effective and truly legal regimes within the fragmented and mostly quite rudimentary institutional frameworks for the global economy. Comparable in terms of legal character and effectiveness to the WTO regime, the international investment regime is arguably more advanced, as it fully incorporates the most important and directly affected non-state actors. In a longer-term perspective, claimants (and their lawyers), who are essentially driven by private interests, help ensure greater compliance and effectiveness for the treaties and their underlying objectives than can or is achieved by exclusively inter-state implementation procedures. It also goes beyond the prospective-remedy-only sanction available under the WTO…. Investment arbitration is arguably the most astounding success in international law over the past decades….*

The strength of the current regime is reflected in the rising number of treaty-based international investment disputes, which, cumulatively, had reached at least 608 by the end of 2014, involving 101 governments (figure 10). The five countries with the highest number of known treaty-based disputes were, at the end of 2013: Argentina (53), Venezuela (36), Czech Republic (27), Egypt (23), and Canada (22).

While the international investment regime is strong, it is also fragile and has a number of weaknesses. The regime's fragility is a function of its key characteristics: it is focussed primarily on the protection of foreign investment as its principal objective; it has a wide subject coverage, partly as a result of a broad definition of “investment”, “investors” and various protections; investment protection standards are at the core of the regime; arbitration is the chosen mechanism to settle investment disputes; the regime is shaped by a multiplicity of legal sources; and the regime has a light and fragmented institutional structure (as there is no multilateral agreement on investment). These salient features of the international investment law and policy regime are partly a function of its origin (namely, to protect foreign investors and their investments) and partly a function of its rapid development over, basically, the past two-to-three decades.

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76 The great majority of these disputes were initiated during the past ten years. While this number might appear low (given the number of MNEs and foreign affiliates, combined with broad definitions of “investment” and “investor”, and broad protection guarantees), it should be noted that the number of disputes on which panel reports were issued during the existence of the GATT from 1948 to the end of 1994 (when the WTO came into existence) amounted to only 91. See, Sauvant, “Driving and countervailing forces”, op. cit., p. 259. Note, however, that only states can initiate disputes in the WTO, while investors can do that in the case of applicable IIAAs.
78 For an elaboration, see Karl P. Sauvant and Federico Ortino, Improving the International Investment Law and Policy Regime: Options for the Future (Helsinki: Ministry for Foreign Affairs of Finland, 2014).
These salient features also explain, at least to a certain extent, the regime’s weaknesses. In particular, while the regime is strong in terms of protecting investors, it is less clear that it is satisfactory as seen from the perspective of host countries and other stakeholders. To begin with, there is the question of whether its objective of protecting foreign investors (and, increasingly, facilitating their operations) needs to be complemented with the objective of facilitating sustainable FDI and, with that, sustainable development. This, in turn, has implications for the regime’s substantive provisions (which are currently focussed on protecting investors) and, especially, the need for policy space for host country governments to pursue legitimate public policy objectives. Related to this issue is also the question of whether the regime’s obligations for host countries should be balanced by obligations for investors and perhaps also for home countries.

But the single most important – and urgent – aspect of the regime that requires attention is its dispute-settlement mechanism, that is, the private right to action through investor-state arbitration. As already noted, this is a potent mechanism. Given the growth of FDI, the number of MNEs and their foreign affiliates, the intrusiveness of FDI (involving all aspects of the production process), the great number of IIAs, the broad definitions of “investment” and “investors”, the broad protections enshrined in IIAs, and the fact that infringements on investor rights can take place at any level in a given country (i.e., not only at the national level but also at various sub-national levels), the potential for disputes is substantial. It is a situation that can involve considerable costs for host governments, as disputes are expensive to litigate and the awards that may be rendered can be high. In addition, there is the possibility that certain actions by governments may lead to disputes with investors that, in turn, lead to regulatory chill in national policy-making.

Importantly, developed countries are increasingly becoming respondents in international investment disputes, and this is leading to a change in the configuration of interests of these countries vis-à-vis the dispute-settlement mechanism in IIAs. Investor-state dispute-settlement provisions were incorporated in investment treaties as the BITs movement gathered pace because foreign investors did not trust the legal systems of developing countries. It was furthermore assumed that only governments of developing countries would be respondents, including because at that time their outward FDI was negligible. This changed in the late 1990s, when the United States became the respondent in a number of cases in the framework of NAFTA (and when, later, emerging markets became important outward investors). By the end of 2013, the Czech Republic (27 disputes), Canada (22), Poland (16), the United States (15), and Hungary (12) were the five developed countries with the highest number of known investment treaty claims against them. Of the 568 treaty-based investor-state disputes known at the end of 2013, 162 had an OECD member as a respondent.

With developed countries increasingly becoming respondents in investment disputes, not surprisingly, the investor-state dispute-settlement mechanism has moved to the center of discussions regarding the international investment law and policy regime, especially in Europe. This is reflected in the fact that the European Commission suspended negotiations of the investment chapter in the Transatlantic Trade and Investment Partnership to allow for on-line public consultations on key investment issues. These consultations, in turn, yielded nearly 150,000 replies on investment protection and investor-state dispute-settlement issues, the overwhelming majority reflecting great skepticism. The European Commission concluded that improvements needed to be pursued in particular regarding the protection of the host government right to regulate; the establishment and functioning of arbitral tribunals; the relationship between domestic judicial systems and investor-state dispute settlement; and the review of investor-state dispute-settlement decisions through an appellate mechanism.

But the discussion on the investor-state dispute-settlement mechanism is not limited to Europe. In the United States, the ranking senior Democrat on the Committee on Ways and Means in the United States House of Representative (which committee has as part of its mandate the responsibility for the country’s trade policy) issued a statement in January 2015 in which he laid out his parameters concerning both, the right to regulate and investor-state dispute settlement. More broadly, while the European Union is formulating its own approach to investor-state dispute settlement and IIAs in general, a number of developing countries have also reviewed their approach to these agreements or are in the process of doing so (including Ecuador, India, Indonesia, South Africa) in order to see how these agreements can address current concerns. One way in which this can be done is by circumscribing and clearly defining the various protections contained in IIAs. Some developed countries (led by the United States and Canada) have begun to do just that in order to reduce the likelihood that they become respondents in international investor-state disputes. It is also likely that treaty partners will reserve for themselves in the future certain interpretive powers in relation to treaties, to be able to intervene in disputes should they arise. These developments deserve to be watched closely.

One development that will influence the further evolution of the international investment law and policy regime is the rise of emerging markets as outward investors, complementing their role as host countries. As a result of the rise of emerging market MNEs - not surprisingly - the configuration of interests of these countries is changing as well: having become key active investors in the world FDI market, they now have a stake in the international investment regime as home countries seeking to protect their firms abroad and facilitate their operations (including in other emerging markets), and not only as host countries receiving such investment and seeking to preserve their policy space.

The evolution of China’s BITs reflects this change most clearly - and China has more such treaties than any other country,
bar Germany. Moreover, as documented earlier, China is the largest host and home country among emerging markets. While China’s early BITs clearly reflected its position as a host country (e.g., through limited application of national treatment and investor-state dispute settlement, and her opposition to pre-establishment national treatment), the situation has changed profoundly since then, and the country’s IIAs have become quite similar to those of the traditional principle home countries. In particular, China now accepts full investor-state dispute settlement and more comprehensive substantive provisions in its IIAs, in line with the practice of the developed countries. In recent IIAs, China has also recognized the importance of maintaining health, safety and environmental measures whilst promoting and protecting investment.

It is even possible to pinpoint the date on which China’s home country interests became equal to, or more important than, its host country interests: July 11, 2013. On that day, China agreed, in the framework of the United States-China Strategic and Economic Dialogue, to continue negotiations of an investment treaty with the United States on the basis of pre-establishment national treatment and the negative list approach to exceptions to such treatment – both of which were strongly opposed to in the past. With the rise of China as an outward investor, its interests as a host country to protect its policy space have increasingly been complemented by its interests as a home country to protect the investments of her firms abroad and to facilitate their operations. More generally, with the rise of emerging markets as outward investors, the international investment discussion is increasingly loosing the North-South dimension that characterized this issue during the 1970s and 1980s.

The international investment law and policy regime is in constant flux. The developments outlined above deserve to be closely watched as they most likely will substantially influence how this regime will evolve in the future. This is important because the international investment regime increasingly provides the parameters for national policy making in the investment area. But it is also important for a more fundamental reason: the developments that are underway now will shape how all principal stakeholders in the regime will judge its legitimacy – and any regime that is meant to be stable and predictable needs to be seen to be legitimate because it reflects the interests of all important stakeholders.

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86 See, e.g., the preambles of the 2004 China-Trinidad and Tobago BIT, and the 2004 China-Guyana BIT. See the discussion in Vadi, op. cit., p. 712;  
87 Xinhua, July 12, 2013. In making this important policy change, it might well be that internal policy considerations – in particular its implications for domestic economic reform – were equally important.
KEY OPPORTUNITIES AND CHALLENGES FOR THE FUTURE
CHAPTER 4. KEY OPPORTUNITIES AND CHALLENGES FOR THE FUTURE

A. Inward FDI

The world FDI market is highly competitive. All countries, including many sub-national organizations, compete for FDI. Moreover, this competition takes place in a framework in which national investment laws are becoming quite similar in terms of establishing a welcoming framework for FDI. In addition, the great majority of countries have supplemented and enhanced their national regulatory frameworks with strong international investment agreements. Hence, the challenge for host countries and their investment promotion agencies is to stand out, that is, to distinguish themselves positively from their competitors. This can be done in a number of ways. To illustrate, one particularly effective way is for a location to seek to become a brand name - in other words, develop a reputation for being an excellent location for foreign investors. Achieving this status is not easy, but it can be done: Singapore is an example, and so is Bangalore (in distinction to India). Apart from the relevant basic economic determinants being in place, a clear, transparent, stable, and enforceable regulatory framework is important here.

Effective investment promotion agencies are also very important. Many of these agencies are however woefully under-resourced, both financially and organizationally. Given the strategic role that such agencies can have in attracting FDI and helping in a host country’s quest for economic growth and development, having state-of-the-art IPAs should be a priority for countries particularly interested in attracting FDI.

IPAs, in turn, need to make sure that, in seeking to attract FDI, they consider the various reservoirs for additional FDI that exist. To begin with, investors already established in the country should receive priority attention; if they have had a satisfactory experience, it might be possible to convince them to expand their operations (and re-invested earnings are a prime source of FDI) and even bring in other foreign investors, for example, suppliers. This highlights the importance of after-investment services.

But there are also new reservoirs. Emerging market firms spreading their wings are particularly important here, and not only firms headquartered in big countries like Brazil, China and India, but also in the many other emerging markets with firms that are beginning to venture abroad through FDI. (See the earlier discussion on the rise of FDI from emerging markets.) Other reservoirs include sovereign wealth funds, which have a substantial amount of assets available, but whose FDI so far has been negligible. Moreover, many countries are privatizing state-owned enterprises, and many of these have a limited presence abroad; once they are in private hands, they are more likely to look for investment opportunities outside their home countries and, hence, constitute potential targets for countries seeking to attract investment. Small and medium-sized enterprises – and the great majority of enterprises fall into this category – are also subject to the same pressures as big firms to internationalize through FDI, and many of them are still at the beginning of this process; given their limited capabilities they are particularly dependent on the assistance of IPAs. Finally, the increased tradability of services makes the great majority of service companies and, for that matter, the service functions of manufacturing and natural resource firms, targets for investment promotion agencies. In other words, the reservoir of additional FDI is considerable and can be mobilized, depending of course on the nature of the FDI determinants that characterize a given host country.

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88 Regulatory frameworks change of course over time. What might be appropriate here is to discuss planned changes in advance with investors (both, domestic and foreign) in order to obtain their feedback.
89 As noted earlier – see International Finance Corporation, op. cit.
90 See also the finding reported earlier in Harding and Javorcik, op. cit., that US$1 in investment promotion can bring in US$189 in FDI in developing countries.
91 For a detailed blueprint of how to build an effective IPA, see, Millennium Cities Initiative, op. cit.
92 It should be noted in this context that the share of world FDI flows in world gross domestic capital formation is quite small, at around 10 percent, while in individual countries it is much higher. This suggests that the reservoir for FDI is far from exhausted.
Regardless of whether IPAs focus on traditional or new investors, one of their key challenges is to attract knowledge-intensive FDI, especially R&D centers, given the importance of science, technology and innovative activities for economic growth and development. As documented earlier, there is a shift in such activities away from developed countries, opening opportunities for developing countries to attract knowledge-intensive investment, including innovation-related parts of integrated international production networks and the global value chains associated with them. The fact that this shift is in the process of occurring puts a premium on active policies to benefit from it.

But to be successful the policy framework has to be right. In particular, host countries need absorptive capacity and a favorable ecosystem for science, technology and innovative activities. Among other things, this involves strengthening the educational system and especially institutions of higher learning (including their international components), creating centers of excellence, facilitating and encouraging the commercialization of R&D undertaken in public institutions, seeking to develop brands, having adequate intellectual property protection and enforcement in place, providing direct funding for R&D activities, arranging better access to finance for R&D (an important bottleneck in many countries), attracting talent from abroad, exploring the establishment of clusters, fostering entrepreneurship, facilitating the integration of local R&D facilities into global knowledge and production networks, and, perhaps, even offering incentives. For some countries, it may be advisable to engage in smart specialization, that is, focus on one area in which they can develop – and offer – a comparative advantage.

Some countries may also be in a position to impose mandatory requirements to transfer technology and/or establish R&D facilities. However, while the WTO’s Agreement on Trade-Related Investment Measures does not disallow such requirements, an increasing number of IIAs does. Moreover, unless countries are in a strong bargaining position (e.g., because they have a large market), it is difficult for them to do so successfully, as firms consider technology and innovative capacity as core sources of their competitive advantage. Even if countries are successful in imposing such requirements, countries may not attract the most advanced parts of the R&D process, but, rather, for instance, the development or testing parts, even if they had the absorptive capacity for more advanced activities.

In any event, any national efforts to encourage technology transfer and the establishment of innovative capacities need to take place in the framework of a national strategy for technological advancement and, preferably, in the framework of a development strategy for the country as a whole. Such a strategy, moreover, needs to recognize that activities in the knowledge-intensive area are increasingly taking place in a global context. National innovation systems are embedded in this context, and governments need to take this context into account when formulating and implementing national policies. Further, national policies in this area need to recognize that firms typically have a choice among alternative locations – in fact, they are spoiled for choice.

Finally, there is the challenge of conflict prevention and management. With the growth of inward FDI, the number of firms undertaking such investment, the intrusiveness of FDI (involving the gamut of activities related to the production process), the number of international investment agreements, the broad definitions of “investor” and “investment”, and the broad formulation of the various protections contained in these agreements, the potential for conflicts between host countries and MNEs and their foreign affiliate increases (as discussed earlier). Add to that that violations of IIAs can take place not only at the national level but also at various sub-national levels and that, as MNEs see that disputes can lead to awards in their favor (while arbitration costs can be financed by third-parties), the number of claims is likely to increase. As was observed earlier, the number of treaty-based investment disputes has indeed risen considerably. This draws attention to an important challenge that host countries face, namely how to manage the relationships between MNEs and their foreign affiliates on the one hand, and governmental authorities (both national and sub-national ones) on the other hand. And this has to be done in a manner that avoids that the conflicts that are bound to arise reach the level of international arbitration, with possibly substantial financial and regulatory implications for host countries.

93 For a discussion of developments in the policy framework in this area, see OECD, OECD Science, Technology and Industry Outlook 2014, op. cit.
94 Care needs to be taken, however, that incentives do not become “icing on the cake”, i.e., to avoid situations in which MNEs would have located R&D facilities in a given territory in any event, on the basis of the territory’s economic determinants.
One way in which this can be done is through the appointment of a FDI ombudsperson to address foreign investors’ grievances. If the government and the business community respect the ombudsperson, that person can help resolve grievances of foreign affiliates (and, for that matter, of governments vis-à-vis foreign affiliates), thereby preventing grievances from escalating into international investor-state disputes.

Another way to manage conflicts at the national level involves better coordination of government agencies. A few countries have pursued this approach. Peru, for example, has established an inter-ministerial committee that vets any conflicts of this type that arise, with a view toward becoming involved at an early stage of a conflict to be able to take appropriate action for its resolution. It is encouraging in this respect that the World Bank is pioneering an effort to establish an investor-grievance management mechanism in a number of countries, to help governments manage investor grievances relating to, among other things, the following investor-protection guarantees: protection from expropriation, freedom to transfer and convert currencies, protection from adverse regulatory changes, and breach of contract. The mechanism would provide the institutional infrastructure for governments to identify, track and manage grievances arising between investors and government agencies as early as possible and put them in a position to respond to grievances in a timely manner and in accordance with the country’s applicable laws, regulations and international investment agreements.

Managing conflicts between foreign investors and host countries – or, even better, preventing them from occurring – has become a key challenge in the international investment field. Being successful at this is in the interest of host countries, as it helps them to retain existing investors and, beyond that, contributes to a more favorable investment climate that helps countries attract additional FDI.

95 The Republic of Korea is one of the countries with such an institution. It has been credited with resolving investors’ grievances and encouraging reinvestment or more investment; see, “Remarks by Dr. Choong Yong Ahn, Foreign Investment Ombudsman, Republic of Korea, at the 2012 International Agreements (IA) Conference of the World Investment Forum,” available at http://www.investkorea.org/kwork/ombsman/eng/au/index.jsp?num=8&no=600280001&bno=205210048&page1=1&sort_num=546, as well as UNCTAD, A Guide to Investor-State Disputes: Prevention and Alternatives to Arbitration (Geneva: UNCTAD, 2011).


B. Outward FDI from emerging markets

The rise of outward FDI from emerging markets and its characteristics (especially the role of state-controlled entities) has created a number of challenges, each of which also entails opportunities.

The first challenge concerns MNEs based in emerging markets themselves. Because these firms are newcomers in the world FDI market, they face a number of obstacles. In particular, because they lack experience in establishing and managing foreign affiliates (especially if they are integrated in wider production networks and have global value chains associated with them), they need to function on a steep learning curve successfully to enter, operate and prosper in foreign markets. For example, executing cross-border M&As successfully - the principal entry mode for an increasing number of emerging market MNEs - is particularly difficult. Even experienced MNEs frequently fail at it: Daimler Benz’s unsuccessful acquisition (and, ultimately, disinvestment) of Chrysler is a precautionary example. Moreover, emerging market MNEs (like other MNEs) need to overcome the liability of foreignness. This is particularly difficult for emerging market firms, as the gap between the operating environment in many emerging markets and that in many host countries (especially developed ones where more and more FDI originating in emerging markets is taking place) is particularly high. For instance, a survey of executives of Chinese firms conducted by the China Council for the Promotion of International Trade (CCPIT) found that 74 percent of the respondents reported the lack of local connections in host countries as a major challenge facing Chinese outward FDI, 74 percent reported cultural differences and 63 percent reported difficulties adapting to the local living environment. These challenges tended to be more salient for small and medium-sized enterprises than for large enterprises.

Moreover, emerging market MNEs (like other firms) have to be good corporate citizens in their host countries: they need to become insiders, accepted fully by the communities in which they are established. This requires all sorts of actions that emerging market MNEs may not necessarily be very familiar with, such as corporate social responsibility (CSR). Broadly, emerging market MNEs need to pay attention to the impact they have on both host and home countries. In particular, they need to pay attention to the objective of host countries to attract sustainable FDI, defined earlier as FDI that makes a maximum contribution to the economic, social and environmental development of host countries (including their expectations regarding transfer of technology and the establishment of R&D facilities) and takes place within mutually beneficial governance mechanisms while being commercially viable (with fair governance being particularly important in the natural resource sector, where the distribution of benefits between MNEs and host countries is typically defined through contracts). If they do not pay attention to this particular challenge, they may well encounter a backlash. Signs of such a development are already visible: in a number of developed countries, FDI by firms based in countries such as China, Russia and some Arab countries is sometimes regarded with mistrust. This is also occurring in Africa and Latin America. This draws attention to the need for the training of managers of emerging market MNEs and encouraging them to accumulate experience rapidly.

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100 To quote the Governor of the Central Bank of Nigeria: “So China takes our primary goods and sells us manufactured ones. This was also the essence of colonialism.” Lamido Sanusi, “Africa must get real about its romance with China”, Financial Times, March 12, 2013.
101 On the other hand, Chinese private enterprises investing in the manufacturing and services sectors are making inroads in Africa; see Krueger and Strauss, op. cit.; and Shen, op. cit.
102 See, e.g., Miguel Pérez Ludeña, “Is Chinese FDI pushing Latin America into natural resources?”, Columbia FDI Perspectives, no. 63 (2012).
Emerging market MNEs also need to meet other challenges in host countries. As observed earlier, the regulatory environment in a number of host countries is becoming less welcoming to FDI, especially regarding inward M&As in sensitive industries and particularly when M&As involve national champions. Some emerging markets suffer in this respect from the liability of the home country: a number of countries regard some incoming FDI (especially when it takes the form of M&As) from such countries with suspicion, primarily for national security and political reasons. This is particularly the case for emerging markets in which state-controlled entities play an important role in their outward FDI - because these entities are, sometimes, rightly or wrongly, seen as pursuing interests other than commercial ones, and there is concern in host countries that these interests might be detrimental to the national security of host countries. National security concerns, in particular in relation to Chinese SOEs, but also those based in other countries, have led to the creation or strengthening of regulatory review processes of incoming M&As in a number of countries, including Australia, Canada, Germany, and the United States. The September 2012 veto by the President of the United States of a Chinese windmill project near a military base in Oregon – the first such veto in 22 years and only the second one in the history of the Committee on Foreign Investment in the United States – is emblematic of these concerns.

Further, there is concern that state-controlled entities benefit from all sorts of advantages when investing abroad. Some of these advantages are related to structural conditions, such as state-controlled entities having monopoly positions in their home countries, providing them with the strength to compete successfully abroad when acquiring assets. Other advantages are related to the regulatory framework governing outward FDI from emerging markets, to the extent that these countries have such a framework. While, as mentioned earlier, not many emerging markets have frameworks in place that help their firms invest abroad (in contrast to virtually all developed countries), such frameworks may, in the future, be subject to political resistance from certain host countries, at least to the extent that they support the expansion of outward FDI by state-controlled entities. The reason is that, for a number of developed home countries, helping state-controlled entities invest abroad is seen as distorting the competitive outward FDI landscape in favor of these entities in the markets in which they invest -- and has hence become undesirable. For instance, some state-owned international investors seeking to acquire firms in host countries may have a competitive advantage as a result of concessional financing provided by home country governments. The watchword is “competitive neutrality”.

In the international context, this concept means that no entity in an international market should have undue competitive advantages vis-à-vis its competitors. Thus, measures to help firms in their outward FDI, even when available equally to both public and private entities, may in the future be evaluated in terms of their impact on competitive neutrality.

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105 Given certain advantages that SOEs (and state-supported enterprises) are seen to enjoy, Robert D. Hormats, United States Under Secretary of State for Economic, Energy and Agricultural Affairs, argued that: “Under these circumstances, market entry by foreign firms, or foreign goods and services, is either impossible or extremely costly. This is harmful to U.S. interests because it can give select foreign companies unearned competitive advantages in our own market and third country markets as well as in the market of the country applying the measures. So it is a major trade issue as well as a major investment issue -- and requires comprehensive trade and investment norms and disciplines.” See his “Ensuring a sound basis for global competition: competitive neutrality” (Washington: U.S. Under Secretary of State for Economic, Energy and Agricultural Affairs, 2011), available at http://blogs.state.gov/index.php/site/entry/competitive_neutrality, p. 1.
106 The United States Government has been working with OECD member states and the OECD Secretariat to create a multilateral “Competitive Neutrality Framework”, i.e., “guidelines that would address the issues posed by ‘state capitalism’.” Hormats, op. cit., p. 1. For a discussion of the concept of competitive neutrality in the context of outward FDI, see Sauvant et al., 2014, op. cit.
However, international discussions so far have focused only on advantages that may be enjoyed by state-controlled entities, and not by private firms. These discussions are being carried out in the OECD, and the issue has also entered the negotiations of the Trans-Pacific Partnership Agreement \(^\text{106}\) and is expected to be an issue in other upcoming negotiations, \(^\text{107}\) with a view toward imposing disciplines on the availability of measures supporting outward FDI by state-controlled entities. Depending on the outcome of these negotiations, the support that emerging market state-controlled entities obtain when investing abroad may eventually need to be curtailed. It is therefore important to monitor the international discussions in this area. In countries (like China) where IPAs have responsibilities not only regarding inward FDI but also regarding outward FDI, this may be a task that these agencies could assume, as part of their policy advocacy function.

Apart from such a defensive approach, governments of emerging markets that do not have a clear policy regarding outward investment – and it should be recalled that the great majority of emerging markets fall into this category - need to consider whether they should have such a policy (and the instruments needed to implement it). The reason is simple: assume that firms in country A do not receive any support when investing abroad, be it informational, financial, fiscal, insurance, or any other form of support (table 6 lists various support measures), or, perhaps, even have to overcome various obstacles when undertaking outward FDI projects. Assume further that firms headquartered in country B do not face obstacles when undertaking outward FDI projects and even benefit from various support measures made available by their government for outward investment. In this situation, MNEs headquartered in country A have a clear competitive disadvantage vis-à-vis their competitors from country B when undertaking outward FDI projects. This disadvantage is amplified by the fact that most outward investors based in emerging markets are relatively new outward investors and hence have little experience in this regard and are relatively small. If anything, they need help to venture into foreign markets and compete successfully with their counterparts, especially firms based in developed countries benefitting from the support of their own home country governments. Policy makers in countries that fall in the country A category therefore need to consider what, if anything, they should do in this area. In doing so, they may want to benefit from the experience of some of the governments in the country B category, for instance, in the context of exchange-of-experience workshops, to learn what has worked and what not, to be in a better position to make an informed decision.

So what could be done to deal with the reaction in host countries toward outward FDI from emerging markets in order to avoid a backlash and build trust?

To begin, emerging market MNEs (like MNEs in general), and especially state-controlled entities, need to make sure that their investments abroad are well planned, prepared and received. This is particularly important when investments take the form of M&As and are in industries that are sensitive (e.g., for national security or cultural reasons) or involve iconic targets. (Even M&As in other areas may elicit concerns as they are frequently associated with restructuring and the shedding of jobs.) Hence, M&As need to be carefully prepared and implemented, and the benefits of acquisitions need to be spelled out. Moreover, once established, emerging market MNEs need to make an effort to become “insiders”, that is, good corporate citizens that are recognized as such. This can be achieved for example through the creation of forward and backward linkages, including sourcing from local suppliers; by employing nationals in high corporate positions; becoming members of local associations; and engaging in various CSR activities. As to CSR, many foreign affiliates in host countries do already undertake various such activities. They could strengthen these, make them more predictable and, most importantly, make them an integral part of a corporate strategy to contribute to their host countries’ sustainable development.

Governments of emerging markets also have a role to play. Given the relative inexperience of many of their MNEs, these


\(^{107}\) For example, in the context of the forthcoming negotiations of the Transatlantic Trade and Investment Partnership.
governments have a particular responsibility – and interest - in monitoring the manner in which their firms invest abroad, most notably in terms of the impact of investment on host countries: as noted earlier, for host countries, FDI is merely a tool to advance their development; hence it needs to be sustainable FDI (as defined above), and governments may need to provide the necessary guidance in this respect. If they do not do so, any backlash may spill over into inter-governmental relations. For example, they could pay more attention to enforcing the various instruments that they already may have in place to guide the behavior of their foreign investors abroad, or create such instruments. More ambitiously, emerging markets – or at least the bigger ones among them -- could formulate “going-in” strategies. Such strategies would seek to maximize not only the benefits of the countries’ outward FDI for home country emerging markets (and their firms), but also for the economic, social and environmental development of the host countries in which emerging market MNEs invest. A key element of such “going-in” strategies could be to adhere to the OECD Guidelines for Multinational Enterprises. Such strategies could be underpinned by requiring, by law, that outward investors dedicate a small percentage of their earnings to CSR activities in their host countries, especially activities that contribute to their host countries’ sustainable development.

Conceivably, going-in strategies along these lines could also eventually influence the content of international investment agreements and give home country governments a role in ensuring that the outward investment by firms headquartered in their territories has as much as possible the characteristics of sustainable FDI.

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The rise of outward FDI from emerging markets creates threats and opportunities. The principal threat is that the reaction of host countries to this investment becomes strongly influenced by unwarranted suspicions. If that should happen, this would not only be detrimental to the economic development of the new home countries, but would also be detrimental to the economic development of host countries, as these would forego the opportunity of benefitting from the tangible and intangible assets associated with FDI originating in emerging markets, and would further be detrimental to the overall integration of emerging markets into the world economy. Therefore, there is an incentive for emerging markets, the host countries of the outward FDI from these countries and the world economy at large to make sure that policies are adopted that allow countries to minimize any negative effects and maximize the positive effects that spring from the rapid rise of outward FDI from emerging markets. Among other things, this requires that emerging markets participate actively in discussions aimed at improving the international investment law and policy regime, as this regime increasingly sets the parameters for national policies in the area of foreign direct investment.

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109 This would be a variation of what India’s Companies Act 2013 mandates for corporate responsibility spending by the country’s own firms in India. Section 135 of that law (which became effective at the beginning of the financial year 2014-2015) requires that the Board of every company having a net worth, turnover or profit above a designated amount shall take a number of steps to adopt a corporate responsibility policy and ensure that the company spends, in every financial year, at least two percent of the average net profits that the company made during the three immediately preceding financial years, in pursuit of its corporate responsibility policy (The Gazette of India Extraordinary, Ministry of Law and Justice, 30 August 2013, The Companies Act 2013), available at .
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