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World Investment Report

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"World Investment Report"

The UN Conference on Trade and Development (UNCTAD) issues a yearly report analyzing international capital flows: the World Investment Report. The latest issue of the report focuses on what it calls a "shift towards services".

What kinds of services are attracting flows of Foreign Direct Investment (FDI), and in what countries? What is the difference between the "offshoring" of services and "outsourcing"? What countries and regions are poised to attract the most investment capital in the near future?

These are some of the questions discussed in this edition of World Chronicle in the company of Karl Sauvant, Director of UNCTAD's Division on Investment, Technology and Enterprise Development.

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ANNOUNCER: From the United Nations in New York, an unedited interview programme on global issues. This is **World Chronicle.** And here's the host of today's **World Chronicle.**

JENKINS: Hello, I'm Tony Jenkins.

The UN Conference on Trade and Development – known as UNCTA D – is sues a yearly report analyzing international capital flows. The latest issue of the World Investment Report – here it is – focuses on what it calls a "shift towards services". With us today to explain what this means, and what the trends are in the world of Foreign Direct Investment, is the principal editor of the report, Karl Sauvant.

Joining us in the studio are Ricardo Alday of *NOTIMEX* – the News Agency of Mexico – and ... Bet sy Pisik of the *Washington Times*.

Karl Sauvant, as I read this report, there was a drop, last year, of a hundred and twenty thousand million, a hundred and twenty billion in American terms, dollars, that's about an eighteen percent drop of over the previous year of the amount of Foreign Direct Investment, money invested in countries around the world and yet the tone that I pick up from the report is reasonably optimistic. Can you explain that?

SAUVANT: Well, what we have seen since the year 2000 is that world investment flows have declined from 1.4 trillion dollars to 650 billion dollars in 2003 but we expect that the year 2003 has seen the end of the decline and that in the year 2004 we will have an increase of investment flows worldwide, uneven as far as regions are concerned, but overall an increase. And we expect that in the year 2005 we'll see also an increase in investment flows.

JENKINS: OK. One quick question before I hand over to Betsy here, is that within the global numbers there are two other trends that I notice. One is that the amount of money going into the developed world, the United States, Europe etc., has dropped in the case of the United States, quite a significantly and I think we'll get into that later and yet in the developing world, there's been a pick up. Can you explain that? And is this a good thing or a bad thing?

SAUVANT: Well, first of all, factually, it is correct, the decline has taken place primarily in the developed countries and also in the Central and Eastern European countries. The developing countries have become more attractive in terms of attracting Foreign Direct Investment led in particular by Asia, within Asia in particular by India, and also to a certain extent by Africa, which has seen as a result of the commodity boom an increase of investment. The only region

among developing countries which has seen for the fourth year in a row a decline is Latin America but it's a fairly small decline. So even in Latin America we expect that the year 2004 will see an increase in investment .....

JENKINS: I'm sure Ricardo is going to want to ask you about that ... . but Betsy first...

PISIK: I'm curious. You say that 2003 is probably the last of the lagging years. Is that in any way related to September 11 that seems to have gummed up every other economic indicator?

SAUVANT: No

PISIK: It's independent of that...

SAUVANT: Yes. The principle determinants for investment flows are of economic determinants in particular market size, market growth, infrastructure, skills and so on. And what we have seen, that is partly, also explains the increase that we expect for 2004, is that the world economy has picked up again, in particular also in Asia, and as a result companies can invest more. But there are a number of other factors which come into play: increased profitability of companies an increase in stock prices, because in particular among developed countries the principle way of entering a foreign market is through mergers and acquisitions and the good part of mergers and acquisitions are actually paid by stocks. So to the extent that you actually see a recovery of the markets and stock prices go up automatically companies are in a better position to engage in mergers and acquisitions.

JENKINS: You mean they buy the stocks at the companies in the developing world or they use their own stocks as a source of capital?

SAUVANT: Most mergers and acquisitions take place between developed countries or among developed countries. For obvious reasons that's where most of the high value assets are and stocks are being used to pay for the company that is being acquired.

PISIK: When you say that the DFI is going down towards the developed world and increasing in .....

JENKINS: Let's get our acronyms right.

PISIK: I'm sorry, FDI.... Foreign Direct Investment. Basically does it net out or is there money being lost in this? Is the difference traceable to where it's headed or is it... ?

SAUVANT: Well, the down turn continued in the developed countries but keep in mind it is down turned in the sense that instead of investing, for instance, 850 billion dollars

abroad 650 billion dollars are being invested abroad. In other words, the flows are positive with the implication being that the stock for Foreign Direct Investment, after all investment is not perishable, that the stock for Foreign Direct Investment increases, in fact we estimate that the book value of Foreign Direct Investment worldwide is around 7 trillion dollars.

JENKINS: Wow, that's about the same size as the American economy.

SAUVANT: It's bigger than that and at the same time that means what you have is the emergence of an international production system. So what you see is not only an integration of world markets through trade, one third incidentally of which is intrafirm trade, but you also see and integration of the national production systems which is part, if you want, it's a productive core of the globalizing world economy.

ALDAY: You mention that the short term trend points to somehow of a recovery. But how much does the lack of solid recovery in the United States might play out in the future?

SAUVANT: This is going to be, of course, an important variable. If economic growth is a principle variable, driving point to direct investment, then, of course, uncertainty in the United States or in other important areas can make a difference as to how big the recovery is or to what extent the recovery is taking place in the first instance. But so far all the indications are worldwide that we see growth rates this year which are actually quite substantial compared to the last couple of years. From that point of view that particular expectation of economic growth rate will suggest that foreign investments flows increase.

JENKINS: Let me ask one question first. As UNCTAD, are you more concerned, I mean this is the United Nations, which is concerned about development, raising the standards of living in the poorest countries on earth...

SAUVANT: Correct.

JENKINS: Is that your principle focus? In other words, do you not care so much that FDI has dropped for the developed world? Are you more interested in seeing that the developing world gets more?

SAUVANT: Well, of course, the development problematique as such and therefore the performance of developing countries is our key interest and of course that's what we keep a particular eye on. However, in today's world, in today's interdependent world the performance of the developing countries depends to a very large extent on the performance of the developed countries.

JENKINS: Great, OK. But then you take me right into my next question because we all know that the United States currently depends on outside investment from the rest of the world to the tune of one billion dollars a day. You have traced a decline in the United States of fifty-three percent. I think that is something like 30 billion dollars isn't it?

SAUVANT: Correct. Down to thirty billion dollars of Foreign Direct Investment in the US in the year 2003.

JENKINS: Is that a blinking amber signal warning? Is that a warning signal that we need to start to worry? Is that a figure that we need to be worried about?

SAUVANT: Well, there are two aspects to that question. The first one is that thirty billions is the lowest figure in terms of Foreign Direct Investment attracted by the US in about ten years. So in that sense, I would suggest that the attractiveness of the US for foreign direct investors has declined. That's one aspect. And of course, that is something which we expect to be just a temporary phenomenon, in fact we have all the indications that Foreign Direct Investment in the US increases.

JENKINS: Why? In other words, what are the industries, what are people going to want to invest in? I mean, the core centers, if we are talking about, we'll get into this a little bit more I'm sure, but the services trend that you've talked about is a trend that's moving out of the developed world, out of the United States, core centers in India, I think is probably be the most notorious example. The service sector is going to places like India and the manufacturing is going to places like China, why would anybody want to invest in America?

SAUVANT: Well, the principle determinant, as I actually mentioned before, of Foreign Direct Investment is size of the market and growth of the market. There is no market, except perhaps for the European Union that is bigger than the United States, so investment is attracted by big markets to the extent that the economic performance of the US improves it will attract more investment in manufacturing, in services, even in natural resources. In fact, some twenty... some seventy-five percent of investment flows worldwide are between developed countries. That's where the markets are. That's where you'll want to service the customs. From that point of view the abnormal figure for the United States is really explained by something else which is that partly to improve their own performance of the parent companies, companies have actually withdrawn to a large extent credits given to their foreign affiliates. And that is counted then as a decline of investment flows in the United States and the same thing applies also to

European companies. So from that point of view I would expect the Foreign Direct Investment in the US to increase.

ALDAY: And what you call the determinant of this trend is the differential between the dollar vis-à-vis the euro....

SAUVANT: There is a ...the dol lar has declined by about what.. fifteen percent to twenty percent against the euro last year. So in that sense some of the figures which you see reflect actually that particular exchange rate influenced because the figures reported here are all in dollar figures.

JENKINS: So that's the second element on paper that you talked about – the withdrawal of credits. That's really a paper transaction and now you are talking about the currency thing, is also a paper thing, so perhaps there's not so much reason to worry.

SAUVANT: Yes, however, you started out your question by referring to the balance of payments deficit. To the extent that outward investment from the US abroad, outward Foreign Direct Investment, increases as it did last year while inward investment declines, the contribution to the financing of the balance of payments of the United States, the balance of payments deficit of the United States decreases, in other words differently, than in the past, the net flows of inward Foreign Direct Investment versus outward Foreign Direct Investment in the US does not help to finance the balance of payments, rather it becomes an additional drain on the balance of payments.

JENKINS: It's making it worse?

SAUVANT: Yes.

JENKINS: And the long term implications are?

SAUVANT: The long term implications are whatever you think will happen if the balance of payments deficit of the United States continues to be as high as possible. But, as I said before, I expect inward investment to increase again so that the balance of payments implications of the balance of inward and outward Foreign Direct Investment flows for the United States might not be as important as the trade balance and other things.

JENKINS: Betsy...

PISIK: I mean to globalize this a little bit. We keep hearing about these new economic engines that are rising up regionally, the Indias, South Africas and so on and I'm wondering, first of all, do you think that that's sustainable in a meaningful way over time? And second of all, do you see that offsetting whatever blips in the market, the American recovery might

weather? I mean is India and China going to continue to provide that kind of balance that will keep the Asian region rising? In terms of stability and.....?

SAUVANT: Yes, well certainly if you look at the last year or so, you have, in the sense, two engines of world economic growth. The United States and China. And certainly all the indications are that for the foreseeable future China will continue to be an engine of economic growth. In the area of Foreign Direct Investment, which is the specialty of this particular report the picture is that China has been actually in the year 2000 became the most important single host country, which in the past was actually the United States and indeed attracted some fifty-four billion dollars of Foreign Direct Investment, a performance which we expect to continue if not to improve this year driven primarily by economic growth, by size of the market, by skills and you name it, by good infrastructure in particular in the coastal regions.

JENKINS: OK, let's take a quick break here. This is **World Chronicle**, and we're talking about world investment trends with the principal editor of the World Investment Report, Karl Sauvant.

Karl Sauvant, the story of the shift to services which is an underlying theme in this report obviously has positives and negatives. We've already talked a little bit about what the potential positives and negatives are for the developed world. Greater efficiency is more profits for the companies in the United States and in Europe, loss of jobs on the other hand. Let's talk a little bit now about the developing world. What does it mean? Because I can see positives and negatives there too. Perhaps you could tell us about that.

SAUVANT: Well, first of all as far as the shift towards services is concerned, it has indeed been quite dramatic. In the year 1970 approximately twenty-five percent of Foreign Direct Investment was in the services sector.

JENKINS: Should we explain what services mean?

SAUVANT: At that time it meant primarily, meaning over and above sixty percent banking, trading, insurance. Now approximately sixty percent of the stock of Foreign Direct Investment, in other words, of accumulated Foreign Direct Investment and some two-thirds of investment flows are in the services sector. Finance and trade continue to be very important accounting for approximately half. But you have new services coming up like telecommunications, water services and business services, accounting and what have you. So from that point of view you have a complete change in the composition of Foreign Direct Investment overall and within the services sector in particular. Now what does that mean for

developing countries you ask? Well it means that there is an opportunity for developing countries through Foreign Direct Investment in the services sector to improve their services infrastructure and to improve, if you want, systemic competitiveness of their economies which is separate from the question of improving export competitiveness which means that developing countries may be able to export more in terms of services. And not only the traditional services like tourism or so but the services which are coming up in the context of offshore.

JENKINS: Do either one of you want to try and get him to explain in language that our viewers might understand what some of these terms mean?

PISIK: What is the difference between off shoring and outsourcing?

SAUVANT: Outsourcing takes place, if, let's say IBM - United States takes a particular activity, let's say sending out the bills which it has to collect. It gives that particular activity to another company in the United States. That's outsourcing. If IBM – United States takes the same activity and does not give it to another United States company in the United States but to a company abroad, it's off shore.

PISIK: So it's the international version of what's been happening at least domestically for years?

SAUVANT: Which is happening domestically quite substantially since years, and the obvious implication is once you have made the step saying "I want to concentrate on my core competency, whatever that is, everything else I outsource". Once you make that step, it's a fairly small step to say "Well I immediately move it there where perhaps it is cheapest or where I can consolidate my activities". So from that point of view given that outsourcing has already become quite important we would expect that off shoring is becoming considerably more important in the near future.

JENKINS: In other words, once Chase Bank decides to move its back office operation out of Wall Street it doesn't matter if they move it across the river to New Jersey or if they move it to Bangalore, India.

SAUVANT: In principle, not.

JENKINS: All right. But now the report again says that seventy percent of this is going to just four countries and three of them are developed countries – Canada, I srael and I forget the third. Only India is benefiting from this. So is there any advantage to the developing world in this trend.

SAUVANT: Well, I think, first of all, we have to look at the underlying factor. The underlying factor is that increasingly services are becoming tradable. In the past, they had to be produced when and where they were consumed. Now they can be produced in one place and consumed, perhaps later, in another place. So that makes potentially all services tradable or all services that have a high information content tradable. Most of this off shoring has taken place among developed countries. The leading ones are indeed Ireland, Canada and Israel plus India actually is number two.

PISIK: And is it necessary, I mean, is it worthwhile noting that all of them have a significant English speaking populous?

SAUVANT: Yes, that's important. That is important and language is indeed a factor but it is not the only factor. I think what is important is, and this is where the developing countries come in,...what is important is that what you are seeing there is development of an international division of labour in the production of services and, as in the case of manufacturing, most of this international division of labour will play out between developed countries but a good part of it will also play out and will involve developing countries. And in fact the growth areas on off shoring at the moment are particular a number of developing countries and countries of Central and Eastern Europe. But the potential, the potential is much larger than what we have seen. In fact, we are saying that what you see is the tip of an iceberg. And in fact you might be, you might be approaching a tipping point in terms of off shoring because according to some .....

JENKINS: Tipping where? Eastern Europe, Africa. I mean, Africa is the one continent that the UN would desperately want to see get going but I don't see services moving to the Democratic Republic of the Congo, for example.

SAUVANT: Correct.

JENKINS: And I'm sure Ricardo will want ask you.... Well maybe I shouldn't say what he wants to ask you...

SAUVANT: I think the picture will be that most of the off shoring will continue to take place between developed countries. Among developing countries it is correct that at the moment there is a high degree of concentration. But in principle nothing prevents Ghana or South Africa to attract off shoring activities. In fact they do. They do.

JENKINS: They need better education systems for starters.

SAUVANT: Education system. You need education systems ...

JENKINS: Infrastructure...

SAUVANT: You need infrastructure, in particular telecommunication infrastructure, you need a regulatory framework, for instance privacy protection is becoming more important and you need another number of factors of this kind. But on the other hand, you don't have to have a telecommunications infrastructure for the entire country. What you need is, you know, a secure telecommunication infrastructure for a particular place, it could be Bangalore or it could be Lagos, or wherever the name of the situation is...

ALDAY: Let me bring it a little bit to my region of the world. The report makes a case on Latin America having a decline in foreign direct, in FDI for the fourth year in a row. Can you explain to us why? And secondly, what is the trend... i s there anything those countries can do to make themselves more attractive?

SAUVANT: There are, I think, two major reasons for the decline for the fourth year in a row of Foreign Direct Investment flows to Latin America. First is that the economic performance, in terms of economic growth in Latin America was not overwhelming for the last couple of years especially compared with other regions of the world, particularly Asia. That is one important factor. The other important factor was that in a sense that you had during the 1998, 1999, 2000, there were a number of very important privatizations in Latin America and these were, if you wish, to a certain extent one of the activities that have attracted Foreign Direct Investments. So what we are seeing to a certain extent is a return to normal, to a normal situation where the specific impact of privatization is taken care of.

ALDAY: And what's the outlook? Is there anything they can do to make themselves more attractive?

SAUVANT: The key, the key variable will remain economic performance and the outlook of economic performance in Latin America is positive.

ALDAY: How much of a threat in this is China? Many countries in the region are always looking for excuses outside their own borders?

SAUVANT: Yes. There is some indication that for instance some of the maquiladora operations in Mexico have moved to China. But on the other hand the maquiladora have picked up in the last couple of years by upgrading and going in more .....

JENKINS: Can you just explain the maquiladora?

SAUVANT: I think that should be done by you...

ALDAY: The maquiladora is production of autoparts and other components that take advantage of cheap labour.

JENKINS: The components are produced elsewhere in the United States and Canada and they are then shipped to Mexico, assembled and then re-exported.....

SAUVANT: It's a kind of export processing zone where particular conditions apply in terms of importing materials, upgrading them and exporting them. But you should also look at China not only as a threat but as an opportunity. For instance, we have indications that Chinese enterprises may invest several billion dollars in Latin America, particularly natural resources and that is actually...

JENKINS: But that's another one of the very interesting trends that is pointed out in the report is that, in fact, one of the major growth areas in FDI, in Foreign Direct Investment, is from one developing country to another developing country. Do you want to say something more about that?

SAUVANT: Yes. Well, traditionally when we talk about transnational corporations or multinational corporations one thinks of big companies from the north. Now this is wrong in two respects. First of all these are ...the mul tinational corporations, at least the transnational corporations, as defined by the UN, are any enterprises controlling assets abroad and we estimate that there are at least sixty thousand of these enterprises. So obviously more of these are small and medium sized enterprises. That's the first one, transnationals are also small companies. The other thing is that an increasing number of companies from developing countries also become foreign direct investors or transnational corporations...

JENKINS: Why? Don't they have enough market at home, enough cheap labour at home. Why does it make sense for them to ..?

SAUVANT: They are subject to the same pressures as companies in the north are. Namely, that in a liberalizing and globalizing world economy competition is everywhere, be it through imports, be it through inward investment and therefore in order to survive in this competition you yourself, be it now an enterprise in the United States, in Hungary or in India increasively have to have your own portfolio of locational assets in order to be competitive not only on your market, but in other markets, and in fact this portfolio of locational assets becomes a sources of competitiveness of competitive strength in a globalizing world economy.

JENKINS: OK, we've touched on just about every other region around the world how about the Eastern Europe because another one of the curious things in you report is that the flow of investment into Eastern Europe, including from Western Europe, is dropping. One would

expect especially since these countries have just been embraced and joined the European Union. Can you explain that one?

SAUVANT: The flows into Central and Eastern Europe over the past decade have increased every year except during the year 2003 and that was largely the result of a decline in privatization instances in Slovakia and the Czech Republic. But the underlying forces are as you indicate extremely positive: you have growing markets, you have skills, you have cheap labour, you have a good tax regime, you have access now to the Western European markers, so we would expect that Foreign Direct Investment into Central and Eastern Europe will pick up.

JENKINS: So it seems to me that just about everywhere in the world you are saying that whatever this report says on the negative side the outlook if pretty positive and I think that's probably a fairly good note on which to end Karl Sauvant because that's all the time we have. Our guest today has been Karl Sauvant. He is the principal editor of the World Investment Report issued by the UN's Conference on Trade and Development. He was interviewed by Ricardo Alday of *NOTIMEX*....and Be tsy Pisik of *The Washington Times*.

I'm Tony Jenkins. Thank you for joining us. We invite you to be with us for the next edition of **World Chronicle**.

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