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The Changing World of Foreign Direct Investment

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Transnational corporations (TNCs) have become the prime drivers of globalization. They now account for more than two-thirds of international trade (of which about one-third is intra-firm trade) and an even greater share of industrial research and development (R&D), as well as significant shares of employment in many countries. UNCTAD estimates that foreign affiliates employ about 54 million people around the world. In 2000, more than 50 countries, of which almost half were developing ones, had an inward stock of foreign direct investment (FDI) valued at more than $10 billion. For developing countries as a group, FDI furthermore represents the largest source of external finance.

Virtually all countries – rich and poor – today expend considerable resources and efforts to lure international investments by these firms into their territories. The views expressed on the merits and perils of FDI continue to diverge, however, and the debate continues.

Few would contest that FDI can contribute to economic development. Contrary to most other capital flows, potential benefits are linked to the inflow not only of capital, but also of technology, knowledge, employment opportunities and better access to international markets. In some developing countries, notably in Asia, the influx of FDI was instrumental as an impetus to economic growth and rapid expansion of trade. In some countries, such as Singapore, Ireland, Costa Rica, China and Malaysia, inward FDI has greatly contributed to the raising of living standards and upgrading of their economies. Home countries have also benefited from the outward expansion of their companies, with export growth, the facilitation of more investment in R&D and a gradual transition towards activities with a higher value added. This applies increasingly also to developing countries. Between 1990 and 2000, the share of developing countries in the stock of global outward FDI rose from 5 per cent to 12 per cent. Moreover, five of the world's largest 100 TNCs are based in developing countries.

On the other hand, the growth of TNC activities fuels rising concerns. There is fear that this process is leading to an erosion of national sovereignty, increasing the risk of labour abuse, hampering competition, is detrimental to the environment and resulting in a concentration of economic power in the already rich countries. Depending on the manner in which the investment is made, both inward and outward FDI have been perceived as threats. Somewhat simplified, outward investment in the form of the establishment of new companies and plants tends to be viewed as a part of a process of relocation of production with job losses in the home country as a result. Meanwhile, in capital importing countries - at all levels of development - foreign acquisitions often give rise to concerns and are sometimes interpreted as a sign of weakness. In reality, of course, things are more complex. From a host country perspective, a takeover can sometimes be more beneficial than a greenfield investment, and vice versa. It all depends on the specific circumstances (UNCTAD, 2000).

In our opinion, the optimistic and pessimistic viewpoints are both relevant and have to be carefully taken into account by policymakers. In a

globalizing world economy, international investment is undoubtedly a key to development. Nonetheless, benefits from FDI must not be taken for granted; and an over-reliance on FDI involves risks. This is where policies come in – at the levels of host countries and home countries as well as at the multilateral level.

Policymakers in developing countries face a difficult task in designing and implementing an appropriate framework not just to attract FDI, but to benefit fully from it. Therefore, policymakers have to have a clear idea of the role they would like TNCs to play in their economies and how FDI can be used as a part of the overall development strategy of a country.

This task has in some respect been made even more complex by globalization, as it offers TNCs new investment opportunities worldwide. While this will contribute to a more efficient allocation of resources at the global level, it also unleashes competition among different locations offering similar locational advantages, especially low-skilled, low-cost workers. In this market segment, competition is intensive, and FDI tends to be footloose.

More competition among host countries leads to higher demands on the side of the investors. Low-cost labour remains a source of competitive advantage for countries, but its importance is declining. Rather, countries have to pay attention to factors such as access to international markets, skills, quality of infrastructure, domestic enterprise capabilities and industrial clusters. These are not only key to attracting more desirable forms of FDI, they also help host countries to appropriate more benefits from FDI inflows through a better absorptive capacity.

In principle, governments have to address four different issues that free markets are unable to address:

- Information and coordination failures in the international investment process that lead to underinvestment in poor countries.
- Infant industry considerations and the risk for crowding out domestic enterprises.
- Enhancing the dynamic benefits (as opposed to static ones) from inward FDI.
- Minimize the risk for abuse of market power by TNCs.

The first area is related to the need for provision of information on investment opportunities and conditions in a country and is linked to the role of investment promotion agencies (IPAs). A recent assessment showed that there are today more than 160 national IPAs around the world, with many more agencies at sub-national levels, who play a key role in generating investment leads, facilitating investment projects and providing after-care services to existing investors. To face up to increased competition and to increase the chances of reaching specific development objectives from inward FDI, many IPAs are taking a proactive and targeted approach to promote FDI. Successful countries, such as Ireland, Singapore and Costa Rica, have sought to match the strengths of their locations with the corporate strategies driving investment decisions.

The second aspect is frequently an issue of concern, as policymakers here face – apparently – a dilemma. By allowing foreign firms free movement in the host economy, there is a risk that domestic companies are not given enough time to undertake lengthy learning processes and will be outcompeted. On the other hand, restricting foreign entry may hinder the inflow of needed capital, knowledge and technology. Finding the right balance between regulating FDI and permitting competition depends on the specific circumstances with regard to, for example, the level of development, availability of complementary resources and inputs, the size of the market and the competitive climate in which learning takes place. However, the dilemma above is also often overstated as FDI, by producing and distributing income (wages), stimulates aggregate demand

and, thus, the sales of products made by local firms in other sectors of the economy.

The third area connects with the much desired inflow of knowledge and technology. Dynamic benefits from FDI require a local environment conducive to an upgrading of local capabilities. Host country governments must, e.g. make sure that their trade and competition policies, education policies and those regarding the operations of foreign affiliates are adequate in this regard. One important area relates to supply linkages between foreign affiliates and local firms. A lack of efficient domestic suppliers is the most common obstacle to linkage creation in developing countries. Well-targeted government intervention – especially when undertaken in close collaboration with the private sector – can tilt the balance in favour of more linkages (UNCTAD, 2001).

Finally, whether inward FDI will contribute to a country's development also depends on the bargaining power of the country vis-à-vis the investor. In situations when a TNC can consider multiple alternative locations for a project and when the host country is relatively small, its government may feel obliged to offer the investor excessive incentives, with a reduction of the beneficial effects from the actual investment as a result. Multilateral rules regulating the use of subsidies can be of help in this regard to prevent harmful competition among countries. Other key areas that have to be addressed include competition policy as a tool to stop TNCs and other firms from abusing their market power, not least in the context of mergers and acquisitions; environmental legislation; and measures (such as double taxation treaties) to restrict the use of transfer practices aimed at tax evasion.

In short, to increase the chances of inward FDI resulting in greater benefits to a host economy, policymakers have to tackle a range of complicated issues. There is no quick fix, or one-size-fits-all solution, to apply in every country.

What then are the prospects for more FDI to poor countries? FDI flows to developing countries as a group have increased over time, also to the poorest ones, albeit from a very low level. In 2000, the 49 least developed countries (LDCs) together received a mere 1.8 per cent of FDI to all developing countries, while their corresponding shares of GDP and population were 2.9 per cent and 13.3 per cent respectively. Moreover, 40 per cent of all the flows to LDCs went to one single nation, namely Angola, predominantly into the petroleum industry.

This suggests that there should be ample room for improvement with regard to the role FDI may have in the development of poor countries. In fact, in the globalizing economy sustainable poverty-reduction will be extremely difficult to achieve without FDI that helps countries become better integrated in the world economy. In light of the trend of falling official development assistance, FDI becomes even more important (for example, while official development assistance to the LDCs fell from $16.7 billion to $11.6 billion between 1990 and 1999, inward FDI to these countries increased from $0.6 billion to $5.2 billion).

Investment opportunities exist in several areas. The extraction and processing of natural resources – which remains the main FDI sector in most African countries - and the tourism industry offer considerable potential in many developing countries. Moreover, trade liberalization and increased specialization of production activities create scope for low-income economies to attract FDI into export-oriented production of labour-intensive production of goods and services.

However, such investment opportunities are often not well known to corporate executives. From the news media they are fed with reports dominated by accounts of civil unrest, starvation, epidemic diseases and economic disorder. While such problems undoubtedly exist in some developing countries, the tendency to lump all poor countries together in a single negative stereotype is wrong,

and is damaging their prospects of development. Instead, investors need to look country by country, industry by industry and opportunity by opportunity.

There is scope for additional efforts. In particular, policy-making at the international, regional and national levels need to be made more complementary. Developing countries still have some way to go in opening their markets to exports from developing countries, especially in areas where the latter enjoy comparative advantage. Moreover, new opportunities for developing countries to attract export-oriented FDI in light of the economiy slowdown and increased competitive pressure on producers may be jeopardized by protectionist measures among the rich nations.

To realize the full potential of FDI for development, action on the part of governments in both host and home countries, the private sector and the international community is needed. While many poor countries have come a long way in terms of regulatory and other reforms to improve their attractiveness to FDI, the work is still unfinished, especially in terms of avoiding too much red tape and increasing transparency. Moreover, there is a great need for additional improvements of the policy framework and domestic capabilities to better benefit from whatever FDI that comes.

Home countries and the international community can do more in terms of helping with the dissemination of existing opportunities and by offering technical assistance in relevant areas. Admittedly, much is happening already at the international level. A number of international organizations (including UNCTAD, the World Bank and UNIDO) provide technical assistance and capacity-building in the area of investment promotion, investment policy analysis and linkage development. There are also several schemes in place to reduce the risk associated with investment in poor countries, such as those managed by the Multilateral Investment Guarantee Agency and the regional multilateral development banks. Other relevant initiatives include those aiming at providing improved access to developed country markets, for example in the context of the EU's Everything-but-Arms initiative or the United States African Growth and Opportunities Act (AGOA). Over the past decade, there has furthermore been a rapid increase in the number of double-taxation treaties, bilateral investment treaties and regional investment agreements. Most recently, the investment dimension was mentioned in the Doha Declaration as a new area to be considered for a multilateral agreement.

Finally, greater attention is also being paid to the role of TNCs themselves. Given their role as agents of economic growth and as principal drivers of the globalization process, there is more space for them to pursue corporate strategies that are in tune with the interest of societies at large. The notion of corporate social responsibility of TNCs encompasses a broad range of issues, including environmental, human and labour rights. The UN Global Compact, the OECD Guidelines on Multinational Enterprises and other international initiatives that are embraced by a growing number of TNCs aim at encouraging stronger commitment on the part of global firms to respect commonly accepted human values around the world. More can be done to raise the awareness among governments, media and NGOs in developing countries of the content of such guidelines as well as to encourage more widespread adherence to the principles stated therein by TNCs around the world.

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