Critical and Emerging Issues for Development in the Context of a Changing Global Economy

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Attracting and benefitting from FDI

by

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Attracting and benefitting from FDI

I should like to deal in my introductory remarks with several sets of facts relating to FDI and mention, for each of them, some policy implications.

The first set of facts relates to the growth of FDI flows and the interrelationships between FDI and trade, and policy implications in this area.

1. The growth of FDI flows and interrelationships between FDI and trade

Three observations, in particular, are noteworthy here:

1. World FDI flows have grown dramatically over the past decade and a half, from US$40 billion at the beginning of the 1980s to US$450 billion in 1998 -- a tenfold increase. Incidentally, 15 per cent now come from developing countries (compared to 2-3 per cent at the beginning of the 1980s). The cumulative total of world FDI flows -- the world stock of FDI -- is now about US$4 trillion, giving rise to international production by foreign affiliates of about US$9 trillion. This compares with world exports of US$6 trillion. As a result, FDI has become more important than trade in terms of delivering goods and services to foreign markets.

2. Increasingly, this stock of FDI is reorganized by foreign investors -- TNCs -- in a
manner in which foreign affiliates become integral parts of corporate networks within which any part of the value chain can be located abroad. The result is the integration of national production systems into an integrated international production system (IIPS) -- the productive core, so to speak, of the globalizing world economy.

3. Within this IIPS, FDI and trade are closely intertwined -- in fact, to such an extent that some one-third of world trade consists of intra-firm trade. Indeed, given that, within their corporate strategies, any firm can decide to locate any part of its value chain wherever it is best for it to convert global inputs into outputs for global markets, FDI and trade flows are increasingly being determined simultaneously. They are both immediate consequences of the same locational decision. To put it differently: increasingly the decision where to locate is a decision where to invest and from where to trade. And it becomes a FDI decision, if a foreign location is chosen. It follows that, increasingly, what matters are the factors that make particular locations advantageous for particular activities, for both domestic and foreign investors.

The policy implications of these broad developments are equally broad: with FDI having become the major mechanism through which countries are linked to, and integrated into, the world economy, you, as policy makers may need to look at international economic relations increasingly from a FDI angle, and no longer only from a trade angle. This, in turn, needs to be reflected in the formulation of national policies and the priorities set at that level.

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

Let me turn very briefly to Venezuela -- “very briefly” because you know, of course, the situation of your country, while I only see glimpses of it, in this case in relation to FDI. The data which we have -- and which will be distributed tomorrow -- suggest that the potential of Venezuela to attract FDI is far from exhausted. If that is indeed the case, the issue becomes a political and administrative one, namely whether the government wants to attract more FDI as a complement to domestic investment and, if so, how to create the appropriate framework.

Let me also say a word about outward FDI, i.e., Venezuelan direct investment abroad. There, it appears, that a number of Venezuelan firms are indeed quite active abroad in terms of outward FDI. In fact, PDVSA made it into the list of the world’s largest TNCs (rank 73) in terms of size of foreign assets and it occupies place 2 on the list of the largest TNCs from developing countries.

Outward FDI is becoming increasingly important as a source to gain access to markets and to increase a firm’s international competitiveness: as protective barriers to trade and FDI fall, fewer and fewer profit reservations remain. The fierce winds of competition blow everywhere. A portfolio of locational assets becomes therefore a source of corporate competitiveness, regardless of whether the firms involved are big or small; in natural
resources, manufacturing or services; or whether they have headquarters in developed or developing countries.

To return to inward FDI: the developments over the past decade have shown that the global supply of FDI is quite elastic. In fact, we do not know what the limits of this supply are. Given that FDI worldwide represents only about four per cent of gross domestic capital formation (about eight per cent for the developing countries as a group), it may well be that FDI flows could reach substantially higher proportions (and levels). Another policy implication is therefore that countries or groups of countries having an attractive investment climate ought to be able to attract significantly higher amounts of FDI flows than they have done so far. At the same time, it needs to be underlined that even if FDI inflows increase substantially, they are a complement to domestic investment, even though they may well be able to play a catalytic role in economic development.

Let me now turn to the second set of facts, namely the diversification of the sources of FDI, and policy implications in this area.

II. The diversification of the sources of FDI

Three facts, in particular, are noteworthy here:

1. The number of important home countries has risen dramatically. During the 1970s, two countries (the United States and the United Kingdom) had FDI outflows of three billion dollars or more. In 1995, seventeen countries had FDI outflows of three billion
dollars or more -- including four developing economies, all from Asia (China, Hong Kong, Republic of Korea, and Taiwan Province of China). More generally, FDI from developing countries -- as I mentioned already -- now accounts for fifteen per cent of world FDI flows. These fifteen per cent alone represent an amount higher than world FDI flows in 1983. And most of these flows stay within the region. In the case of Latin America, Chile, for example, is becoming an important regional investor.

2. The diversification of home countries reflects that more and more firms have become transnational. Indeed, we estimate that there were 7,000 TNCs in fourteen of the more important home countries at the end of the 1960s, by the beginning of the 1990s, this number had increased to 27,000. Worldwide, at least 40,000 TNCs exist. This number, obviously, includes many SMEs, which constitute a reservoir for FDI that has barely been tapped.

3. The sectoral structure of FDI has changed dramatically: today, some two-thirds of FDI flows are in services, ranging from banking and trade to roads and hospitals. At the same time, services' firms are less transnationalized than manufacturing firms -- suggesting that services' firms, too, represent another reservoir for FDI.

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

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

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

Madame Chairperson,

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

Let me therefore now turn to the third set of facts, namely the trend towards liberalization, and policy implications in this area.

III. Liberalization

There are, unfortunately, few systematic data in this area, but those that exist are impressive: in 1997 alone, 135 out of 151 changes in the FDI regimes of 76 countries went in the direction of creating a better climate for FDI. If one takes the period 1991-1997 as a whole, 94 per cent out of 750 FDI policy changes went in the direction of greater liberalization. The direction of this change is important because, what happens at the national level is often the basis of what happens at the international level.

Indeed, these unilateral national efforts at liberalization are complemented by facilitation and protection efforts at the bilateral level, where the principal instruments are double-taxation treaties (DTTs) and bilateral investment treaties (BITs). At the end of 1997, nearly 1,800 DTTs and more than 1,500 BITs were in existence. In the case of BITs, more than two-thirds had come into existence during the 1990s. Some 169 countries participate in them, including, increasingly, developing countries concluding DTTs and BITs with other developing countries. (UNCTAD assisted the G-15 to negotiate BITs between themselves). While the role of BITs should not be overestimated, they can create precedents, for example, for the FTAA.
At the regional level, too, governments seek to improve the framework for FDI flows, especially in the context of the NAFTA, the Lome Convention, ASEAN (ASEAN Investment Area was established last Fall), APEC, MERCOSUR and, of course, the FTAA. This reflects the recognition of governments that FDI is attracted by large markets. In fact, today’s regional agreements are really no longer only free trade agreements but more and more free investment agreements as well.

Finally, a word about regulatory developments at the inter-regional and multilateral levels. You are all familiar with the efforts of the OECD to negotiate a free standing Multilateral Agreement on Investment, efforts that have now been abandoned. (It may well be interesting to discuss at one point during this meeting lessons that can be learnt from this exercise.) More importantly, as part of the Uruguay Round, the WTO adopted the General Agreement on Trade in Services (GATS), which covers FDI in the services sector; and an Agreement on Trade-related Investment Measures, which deals with certain performance requirements. And, as you know, a Working Group on the Interrelationships between Trade and Investment is meeting in the WTO to examine issues in the field of its competence. Some developed countries have, in fact, suggested to negotiate a multilateral investment agreement in the WTO. The issue will perhaps be discussed in the preparation of the WTO Seattle Ministerial Conference in November/December this year.

Regardless of what happens at the WTO, it is clear that international treaty activity in the FDI area is substantial and that the developed countries have acquired substantial experience in this area. It is for this reason that UNCTAD has launched a broad-based programme to assist developing countries in issues related to investment negotiations. It is a
programme that includes analytical work, seminars and symposia on key issues, as well as training of negotiators in the interest of capacity building. What is particularly important in this respect is that any investment treaty -- be it at the bilateral, regional or multilateral level -- leaves enough room for developing countries to pursue their development objectives in light of their specific circumstances. In many cases this means that a certain degree of flexibility needs to be built into such treaties, be it in terms of objectives, structure, substantive provisions and/or implementation. To find the proper balance between international obligations on the one hand and flexibility on the other is of course a real challenge.

The policy implications arising from this trend are that countries wishing to attract FDI need to establish state-of-the-art FDI frameworks, without, of course, losing sight of the need to ensure that FDI should ultimately serve the national development effort. This may require a comprehensive stocktaking, e.g. in the framework of the Investment Policy Reviews introduced by UNCTAD. These Reviews seek to assess the role of FDI in a given country, the potential for more such investment, the regulatory framework for FDI, and ways to improve it in order to help realize the identified potential. In any event, the search for an appropriate FDI framework also needs to reach into non-traditional areas, such as the regulatory framework for inward FDI by SMEs; for instance, there may be (perhaps, unintended) obstacles that small investors face, or SMEs may require special arrangements.

But the policy implications arising from the liberalization trend include also that countries must guard themselves against a “race to the bottom” in their policy competition. At the same time, governments need to monitor, emulate and invent “best practices” with respect to FDI, knowing fully that best practices in one country may rapidly become “benchmarks” for
other governments. And such benchmarking is particularly relevant in a regional context. Cooperation at the regional level is, therefore, beneficial for all countries involved. Such cooperation, where it takes the form of creating larger markets, has the added advantage that, as noted before, they are more attractive to foreign investors than smaller national ones.

Madame Chairperson, let me conclude,

More firms from more countries in virtually all industries are investing abroad. All countries, and in many cases provinces and individual municipalities, seek to attract FDI. The world market for FDI is truly global, and it is driven by competition: competition between firms and competition between countries. The challenge is how to formulate and implement in this context a strategy that is tailored to the specific circumstances of Venezuela, in the interest of promoting the country's development.

Thank you very much for your attention.